91-706
No. ——

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

MESA OPERATING LIMITED PARTNERSHIP,
Petitioner

v.

U.S. DEPARTMENT OF THE INTERIOR,
Respondent

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

PETITION FOR A WRIT OF CERTIORARI

DANIEL JOSEPH, P.C.*
JERRY E. ROTHROCK
MICHELLE L. GILBERT
AKIN, GUMP, HAUER & FELD
1333 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 887-4000

THOMAS H. HAWKINS
MESA OPERATING LIMITED PARTNERSHIP
Suite 1400
5205 N. O'Connor Blvd.
Irving, TX 75039-3746

Counsel for Petitioner Mesa Operating Limited Partnership

* Counsel of Record

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

77

QUESTIONS PRESENTED

1. Whether a federal court conducting judicial review of the decision of one federal agency should defer to that agency's decision that limits the applicability of, and necessarily interprets, a statute administered by a second federal agency and decisions and regulations of that second agency—particularly where the first agency's decision conflicts with and disserves the purposes of the second agency's statutes, and those regulations and decisions.

2. Whether the court below misapplied the standards set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984), in order to find that the DOI's decision, requiring producers of natural gas on federal leases to pay increasingly higher royalties as the quality of gas decreases, reflected a "reasonable" interpretation entitled to deference.

PARTIES TO THE PROCEEDING

In addition to the parties listed in the caption, Phillips Petroleum Company, Amoco Production Company, Anadarko Petroleum Corporation, BHP Petroleum (Americas) Inc., Chevron U.S.A. Inc., Exxon Company U.S.A., Hunt Oil Company, Kerr-McGee Corporation, Marathon Oil Company, McMoran Oil & Gas Company, Mobil Exploration & Producing U.S. Inc., ODECO Oil & Gas Company, OXY USA, Inc., Shell Oil Company, Sonat Exploration Company, Texaco Inc., Union Texas Petroleum Corporation, and Union Oil Company of California were amici curiae in support of petitioner in the proceedings below.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES: Page

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. ——

MESA OPERATING LIMITED PARTNERSHIP,
Petitioner

v.

U.S. DEPARTMENT OF THE INTERIOR,
Respondent

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

---

PETITION FOR A WRIT OF CERTIORARI

Mesa Operating Limited Partnership petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1a-19a) is reported at 931 F.2d 318 (5th Cir. 1991). The opinion of the district court is not reported and is attached hereto (App. 21a-38a). The decision of the Minerals Management Service, signed by the Assistant Secretary of Interior for Land and Minerals Management and the Assistant Secretary of Interior for Indian Affairs, is not reported and is attached hereto (App. 39a-42a).

JURISDICTION

The judgment of the court of appeals was entered on May 15, 1991 (App. 1a-19a), and a timely petition for rehearing was denied on June 27, 1991 (App. 20a). Pursuant to an Order dated September 16, 1991, this Court (by Justice Scalia) extended the date for filing this petition for certiorari until October 25, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

STATUTORY PROVISIONS INVOLVED

The relevant provision of the Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C. § 1337(a) (1986), provides in pertinent part:

> (1) The Secretary is authorized to grant to the highest responsible qualified bidder or bidders by competitive bidding, under regulations promulgated in advance, any oil and gas lease on submerged lands of the outer Continental Shelf which are not covered by leases meeting the requirements of subsection (a) of section 1335 of this title . . . . The bidding shall be by sealed bid and, at the discretion of the Secretary, on the basis of—
>
> (A) cash bonus bid with a royalty at not less than 12½ per centum fixed by the Secretary in amount or value of the production saved, removed, or sold;
>
> (B) variable royalty bid based on a per centum in amount or value of the production saved, removed, or sold, with either a fixed work commitment based on dollar amount for exploration or a fixed cash bonus as determined by the Secretary, or both;

The relevant provision of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. § 3320, provides in pertinent part:

> . . . a price for the first sale of natural gas shall not be considered to exceed the maximum lawful price applicable to the first sale of such natural gas under this part if such first sale price exceeds the maximum lawful price to the extent necessary to recover—

(1) State severance taxes . . .; and

(2) any costs of compressing, gathering, processing, treating, liquefying, or transporting such natural gas, or other similar costs, borne by the seller and allowed for, by rule or order, by the [Federal Energy Regulatory] Commission.

STATEMENT

1. Petitioner's Gas Leases Under OCSLA And Payment Of Royalties Under Its Gas Sales Contracts

Petitioner Mesa leases submerged lands on the outer continental shelf from the Minerals Management Service ("MMS") of the Department of the Interior ("DOI") in order to explore for and extract natural gas. Each of the leases was issued by the DOI pursuant to the Outer Continental Shelf Land Act of 1953 ("OCSLA"), 43 U.S.C. § 1331 *et seq.*, and the regulations contained in 30 C.F.R. § 200 *et seq.* The leases obligate Mesa to pay royalties to the DOI on the value of the natural gas produced and sold from the leased premises. Mesa's royalty obligation is governed by the OCSLA, the leases and DOI regulations.[1]

In most cases, Mesa, like other producers of natural gas, sold the natural gas produced from outer continental shelf leases to pipeline purchasers under long-term natural gas sales contracts.[2] Those contracts generally required the purchaser to pay for natural gas at the maxi-

---

[1] *See* 43 U.S.C. § 1337 (1986) (requiring payment of royalty on the "amount or value of the production saved, removed, or sold"); 30 C.F.R. § 206.150 (1987) (providing that "[u]nder no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from disposition of the produced substances"); *see also* App. 7a (noting that the Mesa/DOI leases, which incorporate applicable federal statutes and regulations, provide for the payment of royalty on 16⅔ percent of the value of "production saved, removed or sold").

[2] App. 7a.

mum price[3] permitted by the Natural Gas Act of 1938 ("NGA"), 15 U.S.C. § 717 *et seq.*, or the Natural Gas Policy Act of 1978 ("NGPA"), 15 U.S.C. § 3301 *et seq.*, and implementing decisions and regulations, which are administered and enforced by the Federal Energy Regulatory Commission ("FERC").[4]

A separate provision in petitioner's natural gas sales contracts authorizes petitioner to perform services for the pipeline purchaser on the natural gas after it is produced, such as gathering, treating, or transportation.[5] As authorized by Section 110 of the NGPA, 15 U.S.C. § 3320 (1982), the pipeline reimburses petitioner for the "necessary" cost of performing these post-production services. Recognizing that these payments for services are not part of the price of gas at the wellhead, Congress specifically provided in Section 110 of the NGPA that such payments would not be counted in computing whether the maximum lawful price for gas had been exceeded. 15 U.S.C. § 3320 (1982). As discussed below (at 7-8), Congress enacted this provision so that the price ceilings would not discourage the production of low quality or poorly located gas. At the same time, to ensure that excessive payments for post-production services would not become back-door payments for the gas itself (which would evade the ceilings set by price controls), Congress in Section 110 required that the FERC issue rules limiting the amount of such payments to the actual cost of the services with no allowable profit. The FERC did so through its Order 94 and supplemental orders.[6]

---

[3] App. 28a.

[4] These ceiling prices are established by Subpart A of Title I of the NGPA, 15 U.S.C. § 3301 *et seq.*, which is titled "Wellhead Price Controls."

[5] Petitioner generally is not required to perform any post-production services in order to collect the ceiling prices established by the NGPA. *See* 15 U.S.C. § 3320 (1982).

[6] *See* FERC Order Nos. 94, 94-A, and 94-B, codified at 18 C.F.R. §§ 271.1100-271.1106 (1990) [45 Fed. Reg. 53099 (Aug. 11, 1980);

Pursuant to the leases and consistent with OCSLA and DOI's royalty valuation regulation, petitioner regularly paid the DOI 16⅔ percent of the amount which petitioner received from the disposition of the natural gas itself.[7] However, Mesa did not pay royalties to the DOI on the Section 110 cost reimbursements. In Mesa's view, as detailed below, these cost reimbursements are not payments for the value of natural gas as produced from the well, but are separately reimbursable costs of providing services to improve the quality or location of the gas after it is produced. Indeed, Mesa's position was that to allow royalties on the Section 110 cost reimbursements would deprive Mesa of the full reimbursement of those costs, which Congress had sought to assure by enacting Section 110, would create the very disincentive to undertake production of low-quality or poorly located price-controlled gas which Congress had sought to avoid, and would create the anomaly that the lower the quality or the poorer the location of the gas, the higher the royalty owed to the government.

2. FERC's Implementation Of NGPA Ceiling Prices

Effective December 1, 1978, the NGPA established the maximum lawful price for the first sale of various categories of natural gas, including natural gas produced from leases of outer continental shelf lands. *See, e.g.*, 15 U.S.C. §§ 3301-3432 (1982). Congress authorized the FERC to administer the NGPA.

The NGPA was enacted in response to regulatory problems which arose after years of natural gas regulation beginning with the Natural Gas Act of 1938 ("NGA"). 15 U.S.C. §§ 717-717(w) (1976).[8] Under the NGA, as

---

48 Fed. Reg. 5152 (Feb. 3, 1983); 48 Fed. Reg. 5190 (Feb. 3, 1983)] [hereafter referred to as "the Order 94 regulations"].

[7] App. 7a.

[8] The NGA introduced cost-based price ceilings for the "sale in interstate commerce of natural gas for resale" and entrusted the

initially implemented by the Federal Power Commission ("FPC"), producers' rates were set on an individual basis.[9] However, this individual cost-based pricing method proved to be impractical and unworkable, prompting the FPC, in 1960, to change to area rate regulation.[10] Under area rate regulation, the FPC set producer prices for a geographic region based on that region's average production, associated costs and average rates of return.[11] In establishing area rates, the FPC specifically included royalty rates in the computation of costs and provided for the adjustment of ceiling prices to account for additional expenses to sellers from increases in royalty payments under certain circumstances.[12] The FPC also recognized the need to make price adjustments for lower quality gas, and accordingly provided procedures for making downward adjustments in the ceiling price for gas with quality deficiencies.[13] Also, because area rates reflected only average costs for a particular region, the FPC began to allow special relief pricing for producers who could establish,

---

administration of this price regulation to the Federal Power Commission ("FPC"). 15 U.S.C. §§ 717(b), c(a) (1976). Originally the NGA applied only to pipelines, calculating maximum prices according to actual costs plus a reasonable rate of return and depreciation. In 1954 this Court expanded the ambit of the NGA to give the FPC jurisdiction over the rates charged by producers offering natural gas for first sale. *See Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954).

[9] *See* Note, Legislative History of the Natural Gas Policy Act: Title I, 59 Tex. L. Rev. 101, 108 (1989) (hereafter "NGPA Legislative History").

[10] *Id.*

[11] *Id.*

[12] *See, e.g., Area Rate Proceeding For Permain Basin*, 34 F.P.C. 159, 206, 220, 224, *aff'd in part sub nom., Skelly Oil Co. v. FPC*, 375 F.2d 6 (10th Cir. 1967), *aff'd in part sub nom., Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

[13] *Id.* at 224-225.

on a case by case basis, higher than average expenses justifying a special exception from area rates.[14]

In establishing price controls under the NGA, the FPC was guided by Congress's express goal of consumer protection, including protection from high prices. The price controls, however, ultimately inhibited the development of new supplies of gas, resulting in gas shortages.[15] In 1978, Congress addressed the problems created by the conflicting goals of consumer protection and the need for increased gas supplies by providing in the NGPA (among other things), national ceiling prices and express forms of incentive pricing for new and certain other categories of gas.[16] One of the incentives was NGPA Section 110, which excepts from the ceiling price regulation certain post-production costs, allowing producers to recover these costs in addition to the unit price for delivered gas from purchasers.[17] This procedure significantly differs from the FPC's prior chosen methodology of allowing downward adjustments in the ceiling price for low quality gas.

FERC implemented Section 110 through its Order No. 94 and supplemental orders authorizing a first seller of natural gas, such as petitioner Mesa, to recover its "production-related costs" over and above the otherwise applicable ceiling price.[18] In setting the amounts to be

---

[14] *Id.* at 225.

[15] *See* NGPA Legislative History at 112.

[16] *See id.*

[17] 15 U.S.C. § 3320(a) (1982). Differing from the other incentive provisions, Section 110 expressly provides that the cost of certain services can be recovered above the maximum price ceiling, whereas the other incentive pricing provisions simply establish higher actual ceiling prices, with various clauses allowing for escalation and in some instances, phased deregulation. *See* 15 U.S.C. §§ 3312, 3313, 3317, 3318 (1982).

[18] 18 C.F.R. § 271.1104(a) (1990). "Production-related costs" is defined to include "costs, other than production costs, that are

recovered, FERC conducted a comprehensive cost study to ensure that producers received such costs as were "necessary" to compensate the producer for services performed.[19]

In 1985 the Fifth Circuit affirmed FERC's implementation of Section 110 as consistent with congressional intent, specifically finding that allowing producers to recover Section 110 cost reimbursements "leads to an important incentive for the production of the lower-quality gas." [20] In so holding, the Fifth Circuit expressly rejected the pipelines' arguments that the amounts set by FERC as recoverable costs were too generous and not "necessary" production-related costs within the meaning of the NGPA. The Fifth Circuit found that FERC had carefully tailored its scheme to ensure that only those costs "necessarily" associated with production-related activities would be recovered by requiring, *inter alia*, that: (1) the sales contract governing the first sale of gas provide that the seller has agreed to provide a specific service; and (2) the evidence establishes that the purchaser has agreed to pay the seller for providing that service apart from an amount paid for the gas.[21]

---

incurred: (1) To deliver, compress, treat, liquefy, or condition natural gas . . . ." 18 C.F.R. § 271.1104(c)(7)(i) (1990). Such costs cover the services at issue here, gathering and transportation services performed by offshore producers. In promulgating Order 94-A, FERC expressly held that such costs are post-production costs. *See* 48 Fed. Reg. 5152, 5153 (Feb. 3, 1983).

[19] *Texas Eastern Transmission Corp. v. FERC*, 769 F.2d 1053, 1061, 1062 (5th Cir. 1985), *cert. denied*, 476 U.S. 1114 (1986).

[20] *See Texas Eastern*, 769 F.2d at 1064.

[21] *See* 18 C.F.R. § 271.1104(a) and (c)(4) (1990); *see also* 48 Fed. Reg. 5159 (Feb. 3, 1983). As an added assurance that only necessary costs would be recovered and to minimize the impact of such allowances on the market, FERC's Order 94 regulations limited the amount recoverable to the lesser of the authorized allowance or the amount provided for by contract between the parties. *Texas Eastern*, 769 F.2d at 1061.

3. Congress Insists That OCSLA Be Interpreted In Light Of The NGPA

In OCSLA, Congress expressed its intent that the DOI confer with other agencies and coordinate the administration of OCSLA with other regulatory schemes. OCSLA's congressional declaration of policy states that:

> the Outer Continental shelf is a vital natural resource reserve held by the Federal Government for the public, which should be made available for expeditious and orderly development . . . *in a manner which is consistent with the maintenance of competition and other national needs*;

43 U.S.C. § 1332 (3) (1986) (emphasis added). Elsewhere, the statute states that in implementing the offshore leasing program:

> management of the Outer Continental Shelf shall be conducted *in a manner which considers economic, social, and environmental values* of the renewable and nonrenewable resources . . .

43 U.S.C. § 1344(a)(1) (1986) (emphasis added).[22] In enacting the 1978 Amendments to OCSLA, Congress made it clear that:

> Of course, other agencies and departments have responsibilities under other laws for OCS and OCS-related activity. One key function of H.R. 1614 is to provide for coordinated Federal action, by limiting duplication of effort, overregulation, and conflicting standards. Thus, the leasing program required by section 18 is to be prepared and promulgated after extensive consultation with other agencies. Regulations, and enforcement of those regulations are required to be after necessary consultation and are to be coordinated.

---

[22] OCSLA also expressly instructs DOI to consult with the FERC regarding development and production plans for natural gas. *See* 43 U.S.C. § 1351(k) (1986).

H.R. Rep. No. 95-590, 95th Cong., 2d Sess. 48 (1978), *reprinted in* 1978 U.S.C.C.A.N. 1455. Courts have confirmed that OCSLA and the NGA, the predecessor to the NGPA, are to be applied reciprocally.[23]

4. The Proceedings Below

On February 27, 1987, Mesa received an audit letter from the MMS demanding that the company pay royalties on all Section 110 cost reimbursements that the company had received after July 28, 1980 for post-production services. On April 9, 1987, Mesa filed an administrative appeal, arguing, among other things, that such reimbursements were not part of the price of the gas and that MMS's royalty demand was in conflict with Congress's intention that, under the NGPA, producers were to be reimbursed for these costs to encourage natural gas production of low quality gas from high-cost offshore leases.

By an opinion dated September 27, 1987,[24] the Director of the MMS upheld MMS's demand for royalties on Section 110 cost reimbursements, summarily concluding that these cost reimbursements were included in the royalty value of the natural gas under the provisions of the

---

[23] *See Continental Oil Co. v. FPC,* 370 F.2d 57, 67 (5th Cir. 1966), *cert. denied,* 388 U.S. 910 (1967) ("plain meaning and legislative history of [OCSLA and the NGA] show, at least in this case, that the [statutes] must be applied reciprocally in furtherance of their individual regulatory purposes"); *see also Public Serv. Comm'n v. FERC,* 589 F.2d 542, 558 (D.C. Cir. 1978) ("because offshore leasing implicates the energy policy alternatives of many agencies . . . the Department of the Interior [has been required] . . . to assess energy factors including FPC activity" when fulfilling obligations under the OCSLA, such as requiring environmental statements on offshore leasing); *cf. FERC v. Pennzoil Producing Co.,* 439 U.S. 508, 520 (1979) (FPC may consider royalty costs when granting rate relief to individual producers); *Bowers v. Phillips Petroleum Co.,* 692 F.2d 1015, 1017 (5th Cir. 1982) (federal regulation of gas prices by FERC implicitly affects amount of royalties, which is based on percentage of market value of gas sold).

[24] App. 39a.

DOI's marketable condition rule,[25] and the provisions of the DOI's royalty valuation regulation.[26] The Director did not discuss whether this holding conflicted with the letter or purpose of Section 110 as implemented by FERC.

On February 22, 1988, Mesa filed the present action in the District Court for the Western District of Louisiana seeking a declaration that the DOI lacked statutory, regulatory, and contractual authority to demand royalties on cost reimbursements that the FERC authorizes petitioner to receive under NGPA Section 110 and seeking an order enjoining enforcement of the DOI's royalty demand.[27] Granting summary judgment for the DOI, the district court dismissed Mesa's argument on the ground that the legislative history of Section 110 of the NGPA did not contain any explicit pronouncement that Congress intended to amend OCSLA.

On appeal, Mesa again argued that the DOI's attempt to expand royalty value to include Section 110 cost reimbursements conflicts both with the language of the royalty provisions of OCSLA and with Section 110 of the NGPA by reducing reimbursements that Congress intended to be recovered by producers to encourage production of low quality gas. Mesa also stressed that the DOI's interpre-

---

[25] *See* App. 29a-30a. The "marketable condition rule" is a regulation promulgated in 1954 by the Secretary of the Interior pursuant to OCSLA's authorization of the DOI to grant and manage leases on Federal lands of the outer continental shelf. 30 C.F.R. § 250.42 (1987 version). The rule stated that the lessee may not *deduct* the costs of treatment in calculating the royalty payment, but made no reference to the value of the production or to cost reimbursements. *Id.*

[26] *See* App. 33a. The "royalty valuation regulation" provides that the value of production for royalty determination shall never be less than the fair market value and in no event, less than the gross proceeds accruing from the disposition of the produced substances. 30 C.F.R. § 206.150 (1987 version).

[27] The district court had jurisdiction over the matter pursuant to 28 U.S.C. §§ 1331 and 1346, 43 U.S.C. § 1349 and 5 U.S.C. §§ 701-706.

tation creates the anomalous result of allowing the government to recover an increasingly greater royalty as the condition of the natural gas at the wellhead deteriorates and producers are required to expend more to improve the quality and location of the natural gas.[28]

Mesa argued that because of the conflict with FERC's regulatory scheme, DOI's alleged long-standing interpretation was not entitled to deference on review. Mesa also stressed that it was ludicrous for the DOI to claim a long-standing interpretation since 1954 when the issue in this case did not even arise until Congress enacted the NGPA in 1978. Any prior interpretation obviously could not have taken into account the plain language of the NGPA (absent in the NGA) expressly authorizing producers to recover Section 110 reimbursements. Mesa further explained that deference was inappropriate because DOI's interpretation ignored Congress's intent that OSCLA be interpreted in accordance with commonly understood terms in the industry that had been developed after a long period of trial and error. Finally Mesa argued that in any event, no deference was due the DOI because its decision was unreasonable and impermissible under *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984).

In upholding the DOI's decision, the Fifth Circuit held that its task on review was defined by the standard of review set forth in *Chevron*: to decide "whether the agency's interpretation [was] based on a permissible construction of the statute." App. 9a. Holding that deference was "especially applicable" in this case, the court deferred to the DOI's interpretation despite that agency's

---

[28] Mesa explained that, under the DOI's scheme, the more a producer has to spend to deliver and treat the natural gas to improve its quality and location over what comes out of the ground, the greater the royalty received by the DOI, even though it is the low quality and poor location of gas as produced—as contributed by the United States as lessor—that make the expenditure necessary.

failure to consider the NGPA or FERC's special expertise when making its determination that royalties were due on Section 110 reimbursements. In particular, the court below thought that the DOI was entitled to deference because the agency had allegedly consistently interpreted the marketable condition rule to require the payment of royalties on "special relief prices" recovered by the producer under the quite different NGA, which the court thought were similar to Section 110 cost reimbursements.[29] App. 13a-14a. But the court did not explain how the former FPC's treatment of special costs under the NGA can, or should, provide authority for interpretation of quite different statutory provisions in the NGPA that were enacted to remedy the NGA's deficiencies.

The court of appeals did not deny that its approval of DOI's assessment of royalties on Section 110 reimbursements resulted in the anomaly of "allowing higher royalty on lower quality gas," but dismissed this result as a mere "consequence of the NGPA/FERC price regulation system . . . ." App. 15a. In response to Mesa's argument that DOI's royalty assessment method meant that the producer could not fully recover costs that Section 110 of the NGPA and FERC's Order 94 regulations intended to be fully recovered by producers to encourage additional gas production, the court of appeals simply held that Congress should have expressly provided that royalties were not due on Section 110 reimbursements if

---

[29] The court of appeals cited the case of *The Texas Company*, 64 I.D. 76 (1957), as alleged support for the proposition that under the NGA pricing arrangement, the FPC had "subjected the NGA special 'add-on' prices to royalty assessment." App. 14a, n.47. Not only does *The Texas Company* not even mention the FPC or special relief pricing, it also did not involve the payment of royalties on recouped costs under OCS leases. Rather, the issue there was whether a lessee under the Mineral Leasing Act could deduct certain costs from the sale price of gas before calculating its royalty obligation. 64 I.D. at 77, 80.

it had intended to provide incentives greater than those under the NGA.[30]

The Fifth Circuit did recognize that FERC's views would have been pertinent to the issue before it. It held that "[a]bsent plain meaning or contrary indications from FERC, [it saw] no conflict." [31] But the court of appeals did not explain why it did not either seek those views itself or fault the DOI for having failed to seek them. Nor did it suggest how FERC's views could or should be obtained on these issues.

Petitioner filed a timely petition for rehearing by the Fifth Circuit on June 12, 1991, which was denied on June 27, 1991. By Order dated September 16, 1991, this Court (by Justice Scalia) extended the time for filing this petition until October 25, 1991.

REASONS FOR GRANTING THE PETITION

1. Introduction and Summary

This case presents an important question that has not been, but ought to be, decided by this Court: the degree of deference that a court conducting judicial review owes to the decision of one federal agency when the agency decision necessarily limits and interprets a statute administered by, and regulations and decisions issued by, a second federal agency. A similar question was urged to

---

[30] App. 16a. The court of appeals claimed—without supporting authority—that Congress knew that the FERC's predecessor agency, the FPC, had allowed royalties to be paid on "special relief prices" before the NGPA was enacted. *Id.* But the court did not explain what "special relief prices" were or why a supposed practice under a prior, expressly different statute by a prior agency was pertinent to Section 110 as implemented by FERC. Nor did the court consider FERC's careful implementation of Section 110 to ensure that producers recover such costs, no more and no less, as were "necessary" to compensate producers for the expense of providing the required services.

[31] App. 17a.

the Court in *Pension Benefit Guaranty Corp. v. LTV Corp.* (P.B.G.C.), —— U.S. ——, 110 S.Ct. 2668 (1990), but this Court declined to decide it because the agency decision being reviewed did not conflict with other law or "trench upon the . . . jurisdiction of" another agency, and because the agency's organic statute did not mandate consideration by the agency of other laws. 110 S.Ct. at 2675 (citing *Burlington Truck Lines v. United States*, 371 U.S. 156, 173 (1962)).

In the present case, however, it is beyond doubt that the DOI decision "trenches on" the jurisdiction of the FERC in two important ways. By holding that Section 110 cost reimbursements are part of compensation for the gas itself—and thus subject to royalty, (1) DOI has treated as part of the price of gas costs that are defined by Section 110 of the NGPA as not part of the price of gas, and (2) because DOI has required Mesa to pay the 16⅔ per cent royalty on those costs, it has denied Mesa the 100 per cent reimbursement of those costs that Section 110, as implemented by FERC's Order 94 regulations, was supposed to assure, pursuant to Congress's desire to avoid the disincentive to produce low-quality gas in a price-controlled environment. Thus, DOI has held that on federal OCS leases the producer cannot recover the full reimbursement of post-production expenses, despite Congress's directive in Section 110 as implemented by FERC Order 94 regulations.[32] Moreover, unlike the situation in *P.B.G.C.*, here the DOI's organic statute, OCSLA, clearly requires the agency to consult with and

---

[32] Under state law, reimbursements for costs such as those subject to FERC Order 94 regulations are not subject to royalty. *See, e.g.*, *Martin v. Glass*, 571 F. Supp. 1406, 1410 (N.D. Tex. 1983), *aff'd*, 736 F.2d 1524 (5th Cir. 1984) (construing Texas law); *Freeland v. Sun Oil Co.*, 277 F.2d 154, 157-59 (5th Cir.), *cert. denied*, 364 U.S. 826 (1960) (construing Louisiana law); *see also Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985) (construing Mississippi law).

coordinate administration of the offshore leasing program with other agencies.

Indeed, the Fifth Circuit freely recognized that the case turned upon the degree to which the DOI decision implicitly interpreted Section 110 and the FERC's Order 94 regulations. To Mesa's argument that the DOI interpreation produced the anomaly that the lower the innate value of the gas the higher the royalty (because the more compensation necessary for post-production costs), the Fifth Circuit acknowledged that this anomaly existed but dismissed it as "a consequence of the NGPA/FERC price regulation system." App. 15a. Indeed, even in dismissing any conflict with the NGPA or FERC, the Fifth Circuit seemed to recognize that FERC's views, if obtained, might be decisive; the Court openly suggested that its decision might be different if there were "contrary indications from FERC . . . ." App. 17a.[33]

Nonetheless, the Fifth Circuit concluded that it would defer to the DOI decision, citing *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984). App. 9a, 10a. But *Chevron* provides no authority for deference to any agency decision like that of DOI in the present case. *Chevron* holds that a reviewing court should recognize that the " 'power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making of rules to fill any gap left . . . by Congress.' " *Chevron*, 467 U.S. at 843 (citing *Morton v. Ruiz*, 415 U.S. 199, 231 (1974)). The Court explained that under such circumstances, deference typically has been granted when the agency decision " 'has depended upon more than ordinary knowledge respecting the matters subjected to agency regulations.' " *Id.* at 844 (quoting *United States v.*

[33] This remark indicates that the Fifth Circuit did not feel that it had definitively resolved the issue, and that there was still room for a contrary result in the event that the FERC's views were contrary.

Shimer, 367 U.S. 374, 382 (1961)). In a case such as this, however, where one agency's decision necessarily interprets and affects laws which are administered by, and are within the special expertise of, a second agency, *Chevron* does not justify a grant of deference. As recently recognized by Justice Scalia, "[n]othing in [the Court's] *Chevron* jurisprudence requires [the Court] to defer to one agency's interpretation of another agency's ambiguous regulation." *See Pauley v. Bethenergy Mines, Inc.*, —— U.S. ——, 111 S. Ct. 2524, 2540 (1991) (J. Scalia, dissenting).

At the same time, however, there exists no decision of this Court that guides a reviewing court in how to approach judicial review of an agency decision, like the DOI's here, that necessarily involves that agency in assessing and making decisions directly affecting the statute, regulations, and policy of a second agency.

This question is an important one. As this Court has long recognized, "[f]requently the entire scope of Congressional purpose calls for careful accommodation of one statutory scheme to another . . . ." *Southern Steamship Co. v. NLRB*, 316 U.S. 31, 47 (1941). Moreover, when a federal agency is faced with overlapping or inconsistent policies embodied in other legislation, this Court has repeatedly stressed that the agency cannot ignore the latter, but must seek to reach an accommodation "without excessive emphasis" on implementation of its own agenda. *Id.*[34] The routine application of *Chevron* by the court below to justify its deference to the DOI decision effectively allowed the agency to avoid this obligation.

---

[34] The agency here, DOI, clearly violated its duty to take into account the overarching regulatory scheme of the NGPA, and particularly, the specific commands of Section 110, as administered by FERC. *See infra* at 19. This portion of the petition addresses, however, the absence of guidelines by this Court to the court of appeals as how to approach judicial review of an agency decision in which such a claim of disregard of another agency's statute and regulations is made.

This Court should accept review to clarify how a reviewing court is to assess the decision of one agency that necessarily interprets or affects the statutes, programs, or policies committed by Congress to another. A clear standard is necessary to prevent the significant problems that otherwise arise when agency decisions are upheld through the improper grant of deference.

2. This Court Should Provide Guidance To Federal Courts Reviewing Agency Decisions That Necessarily Interpret And Conflict With Statutes Or Regulations Administered By Another Agency

As this Court has repeatedly held, an agency is required to consider the policies of another statutory regime within the framework of the legislation it administers when: (1) the agency, in implementing its statutory scheme, trenches upon the jurisdiction of another agency, or renders a decision that actually conflicts with the provisions of other laws;[35] or (2) the agency's own organic law mandates consideration of congressional policies articulated in other statutes.[36] Indeed, "[t]here are good

---

[35] *See Southern Steamship Co.*, 316 at 47; *see also Burlington Truck Lines*, 371 U.S. at 173-74.

[36] *See, McLean Trucking*, 321 U.S. 67, 79-80, 83-85 (1944). In *McLean Trucking*, the Court reviewed the Interstate Commerce Commission's approval of a merger among seven large motor carriers, over the Department of Justice's objection that the consolidation would be anticompetitive. This Court explained that when implementing the policies of the Interstate Commerce Act, the ICC:

> may be faced with overlapping and at times inconsistent policies embodied in other legislation enacted at different times and with different problems in view. When this is true, it cannot, without more, ignore the latter. The precise adjustments which it must make, however, will vary from instance to instance depending on the extent to which Congress indicates a desire to have those policies leavened or implemented in the enforcement of the various specific provisions of the legislation with which the [ICC] is primarily and directly concerned.

321 U.S. at 80.

reasons for this Court's insistence that administrative agencies consider relevant statutes. The objectives of Congress would be ill served if each administrative agency were permitted to disregard any statute that it is not specifically authorized to enforce." *See Community Television of So. California v. Gottfried*, 459 U.S. 498, 516 (1983) (J. Marshall, dissenting).

This case falls squarely within both of these categories. First, DOI's expansive definition of the phrase "value of production" requiring a royalty to be paid on Section 110 cost reimbursements for post-production services directly conflicts with FERC's determination that such cost reimbursements are for services and are not a component of the actual value of gas. As a consequence, DOI's decision abrogates specific rights guaranteed to producers under NGPA Section 110 as implemented by FERC. In praticular, the DOI's decision reduces, by the amount of the royalty payment, the costs that producers can recover, even though under the NGPA, as implemented by FERC, those costs were to be fully recovered to encourage production of low quality or poorly located gas.[37] Second, unlike *P.B.G.C.* or other cases in which agencies have not been required to consider other laws, in this case, Congress clearly expressed its intent in OCSLA that the DOI is to confer with, and obtain the expertise of, other agencies in coordinating the administration of OCSLA with other regulatory schemes.[38]

---

[37] Indeed, the court of appeals' own precedent, which recognizes that the establishment of royalty rates has a significant and direct impact on the pricing scheme implemented by FERC, confirms the existence of a conflict. *See, e.g., Piney Woods*, 905 F.2d at 852 n.14 ("with regard to policy considerations, we first note that because projected royalty payments by gas producers were a cost component of the rate structure, the intent of the regulatory scheme might be undermined when producer profits deteriorate or vanish as a result of greatly increased royalty payments without any commensurate augmentation of sales revenues").

[38] OCSLA's legislative history confirms that the DOI is to manage continental shelf resources so as to "generally reflect the public

Having directed agencies to consider other laws when implementing their own statute under specific circumstances, this Court, however, has not ruled on how a reviewing court is to assess an agency decision made under such circumstances. For example, certain cases that have discussed an agency's obligation to consider other statutory schemes have considered whether the agency could have chosen a remedy that would have created less conflict with another statutory scheme;[39] others have addressed whether an agency's findings made in a proceeding to decide an entity's request for particular relief were adequate and supported by substantial evidence, including evidence of consideration of other relevant laws.[40] It does not appear that this Court has considered the applicability of the rationale underlying *Chevron* deference to cases such as this or otherwise provided a clear standard of review. This Court should provide the necessary guidance for the reasons specified below.

3. This Case Presents An Important Issue Of Administrative Law That Repeats Itself And That Should Be Decided By This Court

This Court should specifically address the issue for several reasons. First, this is not an isolated case; as repeatedly recognized by this Court, "[f]requently the

---

interest," and may implement the leasing program only "after extensive consultation with other agencies," taking into consideration "[i]nformation prepared by one agency, or expertise developed by another . . . ." The primary purpose of a coordinated effort was to avoid the very problems that arose here—"overregulation and conflicting standards." *See* H.R. Rep. No. 95-590, 95th Cong., 2d Sess. 48, 122 (1978), 1978 U.S.C.C.A.N. 1455, 1528.

[39] *See, e.g., Burlington Truck,* 371 U.S. at 174; *Southern Steamship Co.,* 316 U.S. at 48.

[40] *See, e.g., McLean Trucking,* 321 U.S. at 79-80, 88; *see also Minneapolis & St. Louis Ry. Co. v. United States,* 361 U.S. 173, 186, 189 (1959).

entire scope of Congressional purpose calls for careful accommodation of one statutory scheme to another . . . ." *Southern Steamship Co. v. NLRB*, 316 U.S. 31, 47 (1941); *see also Denver & R.G.W.R. Co. v. United States*, 387 U.S. 485, 492-93 (1967) (recognizing that broad responsibility to administer statute consistent with "public interest" is encompassed within broad-directives addressed to several agencies).

The necessity of a clear rule defining when deference is, or is not, appropriate in these cases, is essential to avoid the many significant problems that arise when a court applies the wrong standard of review, effectively allowing one agency to eliminate consideration of the relevant views of a second agency from the administrative process. As illustrated by this case, an inappropriately deferential posture on review inhibits the coordinated implementation of overlapping regulatory programs. The necessary consequence is the creation of unnecessary tension between two statutory schemes. Moreover, excessive deference to one agency's views undermines the development of consistent policy, ultimately requiring parties to chose between rights guaranteed under one statute and the violation of obligations under another. It also leads to the inequitable result that the agency that first addresses an issue, which also may arise in another context before a different agency, will be able to take advantage of the principles of deference to propel its agenda ahead of another's. In this case, the result was especially egregious in that the agency in charge of a narrow, more limited offshore leasing program was able to implement its agenda in derogation of the policy objectives underlying a broader, more far-reaching national gas pricing program.[41]

---

[41] OCSLA was enacted to provide for the leasing of federal lands on the continental shelf and to encourage the development of resources located thereon. *See*, H.R. Rep. No. 413, 83rd Cong., 1st Sess. (1953), *reprinted in* 1953 U.S.C.C.A.N. 2178. The NGPA

If *certiorari* is granted, petitioner would argue that the rationale of this Court's *Chevron* decision requires that, on judicial review of a decision of one federal agency that necessarily trenched upon (or conflicted with) the jurisdiction of another, the second agency is as much entitled to have its views of its statute and regulations considered and deferred to as is the first.[42] Thus, the reviewing federal court is obliged to assure that the first agency obtains and properly considers the views of the second. Otherwise, the happenstance of how particular issues arise in litigation will control whether the agency that Congress intended to regulate a particular area actually has the opportunity to deal with the issues and have its views considered.

In the present case, therefore, petitioner would argue that the court of appeals erred by simply accepting and deferring to the DOI decision because the DOI had given the FERC no opportunity to provide its views on (1) the interpretation of Section 110 of the NGPA and FERC's Order 94 regulations, and (2) the impact of the DOI position on the administration of section 110 and Order 94, and the purposes underlying that statute and decision, and the implementing regulations. The court should

---

establishes a national policy for pricing and production of natural gas sold in inter- and intrastate commerce, *not* just that gas which is produced on federal lands on the continental shelf. Allowing the DOI to elevate its objective of increasing royalty revenues over the broader policy objectives of the NGPA program creates unnecessary conflicts with that program and undermines the national goal of increasing gas production.

[42] Of course, this standard would only apply in those specific situations when it is clear that the agency was required to consider other laws when implementing its own agenda, either because the failure to do so results in a conflict with those other laws or trenches upon another agency's jurisdiction, or because the first agency's organic statute mandates such consideration. Application of the standard only when such conditions are met eliminates the potential for excessive judicial interference that was of concern to this Court in *P.B.G.C.*

further have assured that, having obtained those views from the FERC, the DOI properly took them into account in making its own decision.[43]

Petitioner would further argue that, alternatively, where a federal agency had improperly failed to take account of a second agency's interests, the reviewing court could itself obtain the views of the second agency, by ordering intervention, participation as amicus curiae,[44] requesting the exercise of primary jurisdiction,[45] or other appropriate means. Indeed, requesting the views of FERC has been the practice of the Fifth Circuit in previous

---

[43] This proposed standard is consistent with that which has been identified by the Court of Appeals for the District of Columbia in *New York Shipping Association v. Federal Maritime Comm'n*, 854 F.2d 1338, 1365 (D.C. Cir. 1988), *cert. denied*, 488 U.S. 1041 (1989). There the court suggested that when an agency is required to consider other laws, for an agency interpretation to be considered "reasonable" or "permissible" under *Chevron*, the agency must "adequately explain not only why its interpretation is consistent with the . . . laws [administered by a second agency], but also why it accomplishes the accommodation required (or alternatively, why no accommodation is possible), and why any alternative, more accommodating interpretations were rejected." *New York Shipping*, 854 F.2d at 1365.

[44] *See Mead Corp. v. Tilley*, 490 U.S. 714, 726 and n.11 (1989). In *Mead*, the Court directed a court of appeals to obtain the views of the two agencies responsible for administering the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001 *et seq.*, before deciding whether the statute could be interpreted as authorizing the payment of certain benefits.

[45] *See Port of Boston Marine Terminal Ass'n v. Rederiaktiebolaget*, 400 U.S. 62, 68 (1970); *Far East Conf. v. United States*, 342 U.S. 570, 575 (1952); *see also FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 520 (1979) (remand to Commission was "proper course in order that Commission in the first instance may clearly enunciate whether and to what extent individual relief from area rates will be granted due to the increased royalty costs" resulting from deregulated market prices); *J.M. Huber Corp. v. Denman*, 367 F.2d 104, 116 (5th Cir. 1966) (recognizing Federal Power Commission's expertise in assessing impact of royalty payments on natural gas price regulatory scheme).

cases involving overlapping schemes of DOI's leasing and royalty program and FERC's natural gas production and pricing regulation.[46]

Finally, petitioner would argue, in no circumstance could a reviewing court make up for the failure of one agency to consider matters within a second agency's jurisdiction by undertaking its own assessment of those matters, as the court below did here to at least some extent. This Court in *Mead* rejected such uninformed consideration: "[f]or a court to attempt to answer these questions without the views of the agencies responsible for enforcing [the statute], would be to 'embar[k] upon a voyage without a compass.'" *Mead*, 490 U.S. at 726 (citing *Ford Motor Credit Co. v. Milhollin*, 444 U.S. 555, 568 (1980)).[47]

4. The DOI's Decision Is Not A Reasonable Interpretation Entitled To Deference Under *Chevron*

Even if *Chevron* principles are determined to be applicable to this case, the court of appeals stretched those principles beyond their limits to find that the DOI's decision was entitled to deference. This Court should ac-

---

[46] *See Diamond Shamrock Exploration Corp. v. Hodel*, 853 F.2d 1159, 1161 n.1 (5th Cir. 1988) (in case involving DOI's assessment of royalties on take-or-pay payments received by natural gas producers, court asked for and received amicus briefs from FERC "in an effort to ensure [court's] decision would not interfere with the FERC's authority to set natural gas policy under the NGA and NGPA"); *Huber*, 367 F.2d at 106 (court expressly requested formal brief of FPC).

[47] In this case, the court below could have, but did not, request FERC's analysis of the extent to which royalties traditionally have been treated as recoverable costs, how rates are adjusted when royalties increase or decrease as a result of the quality of gas produced, and the projected impact that decreased revenues to producers resulting from royalty assessments on Section 110 reimbursements will have on new gas production. All such information is within the realm of FERC's expertise and is clearly relevant to any weighing of the respective policy objectives of the OCSLA and the NGPA. *See supra* at 6-7.

cept review to prevent such a misapplication of *Chevron* that essentially allows a court to abdicate its judicial review responsibilities.

Chevron was never intended to be used as a vehicle for courts to avoid their obligations to carefully consider agency constructions of statutes and regulations. *See Pauley*, 111 S.Ct. at 2539 (J. Scalia, dissenting) ("*Chevron* is a recognition that the ambiguities in statutes are to be resolved by the agencies charged with implementing them, not a declaration that, when statutory construction becomes difficult, we will throw up our hands and let regulatory agencies do it for us"). Only after a court determines that an agency's interpretation of an ambiguous statute or regulation is a "reasonable" one, is deference appropriate under *Chevron*.[48] Under the factors identified by courts as evidence of reasonableness, the DOI's decision clearly was not entitled to deference.[49]

First and foremost, the DOI's decision leads to a plainly irrational result. As repeatedly stressed by petitioner, the DOI's decision leads to the anomalous result that the lower the quality of the gas (and therefore, the more a producer must expend to improve its quality), the higher the royalty to which the government is entitled. The absurdity of such a result is underscored by the fact that the only thing which the government has contributed as lessor is the low quality gas; nevertheless, the lower the quality of the resource contributed, the greater the government's recovery.

---

[48] In *Chevron*, this Court held that when an agency has acted pursuant to its authority to fill such gaps, "a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency." 467 U.S. at 844.

[49] In *Chevron*, the Court identified factors that enhance a finding of "reasonableness," including the importance of agency expertise in a complex area, detailed and reasonable consideration by the agency and the need to reconcile conflicting policies within the agency's own statutory regime. *Chevron*, 467 U.S. at 865.

Such an absurd result, in and of itself, should be sufficient reason for refusing to defer to the agency's decision. But when considered in conjunction with the agency's disregard of its obligation to coordinate implementation of its leasing program with other agencies, thereby creating an unnecessary conflict with FERC's Order 94 regulatory program, a finding of "reasonableness" is entirely unwarranted.[50] This Court should accept review to ensure that *Chevron* is not used as a means to uphold such absurd agency interpretations.

---

[50] *See FEC v. Democratic Senatorial Campaign Comm'n*, 454 U.S. 27, 32 (1981); *New York Shipping*, 854 F.2d at 1365 (no deference is due if agency "undervalues or overlooks the policies [the other] laws seek to promote"); *cf. Community Television*, 459 U.S. at 517 (J. Marshall, dissenting) ("[t]here can be no accommodation, careful or otherwise, if an agency refuses even to consider a relevant statute"). DOI's apparent failure to seek the input of FERC, the agency with the most relevant expertise in the treatment of royalties as a part of the cost of gas and the impact that additional costs will have on the NGPA incentive program, undercuts any finding of "reasonableness" under *Chevron*, which stressed agency expertise as a factor supporting deference. In addition, DOI's interpretation, which failed to refer to, much less analyze, the impact of its royalty assessment method on FERC's pricing system, cannot be deemed a detailed, reasonable explanation entitled to deference under *Chevron*.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

DANIEL JOSEPH, P.C.*
JERRY E. ROTHROCK
MICHELLE L. GILBERT
AKIN, GUMP, HAUER & FELD
1333 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 887-4000

THOMAS H. HAWKINS
MESA OPERATING LIMITED PARTNERSHIP
Suite 1400
5205 N. O'Connor Blvd.
Irving, TX 75039-3746

Counsel for Petitioner Mesa Operating Limited Partnership

October 25, 1991

* Counsel of Record

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

No. 89-4775

MESA OPERATING LIMITED PARTNERSHIP,
Plaintiff-Appellant,

v.

U.S. DEPARTMENT OF THE INTERIOR,
Defendant-Appellee.

May 15, 1991

Rehearing Denied June 27, 1991

Jerry E. Rothrock, Daniel M. Joseph, Susan Brooks, Catherine Fairley Spillman, Akin, Gump, Strauss, Hauer & Feld, Washington, D.C., James R. Nieset, Christopher Thompson, Plauche, Smith & Nieset, Amarillo, Tex., for plaintiff-appellant.

George J. Domas, Deborah Bahn Price, New Orleans, La., for amici, Amoco, et al.

Arthur M. (Russ) Meyer, Jr., Sifford, Edson, Meyer & Jones, Dallas, Tex., T.L. Cubbage, II, Jennifer S. Goering, Bartlesville, Okl., for amici Phillips Petroleum Co.

Lisa K. Hemmer, Atty., Dept. of Justice, William B. Lazarus, J. Carol Williams, U.S. Dept. of Interior, Land Div., Appellate Sec., Washington, D.C. for defendant-appellee.

Liskow & Lewis, New Orleans, La., for Amoco, et al.

Appeal from the United States District Court for the Western District of Louisiana.

Before BROWN, POLITZ, and JOHNSON, Circuit Judges.

JOHN R. BROWN, Circuit Judge:

The Director of the Minerals Management Service (MMS) division of the U.S. Department of the Interior (DOI) ordered Mesa Operating Limited Partnership (Mesa), which extracts natural gas from offshore leases, to pay royalties on reimbursement payments made to Mesa by pipeline company purchasers pursuant to the Natural Gas Policy Act (NGPA) § 110.[1] The DOI affirmed the MMS demand order. Mesa appealed the DOI's decision to federal district court, contending that the DOI misinterpreted regulations governing assessment of royalties. After referring the case to a magistrate, the district court rejected Mesa's arguments and entered summary judgment in favor of the DOI. Mesa now appeals to this court.

We hold that the DOI, in affirming the MMS order, made a permissible interpretation of the federal regulations which govern royalties owing from federal natural gas leases. We therefore affirm the district court.

I. Background

A. Statutory and Regulatory Framework

The Outer Continental Shelf Lands Act of 1953 (OCSLA)[2] authorizes the Secretary of the DOI to grant and manage leases for recovery of oil, gas, and other minerals from submerged lands located on the Outer Con-

[1] 15 U.S.C. § 3320(a), *infra* note 10.

[2] 43 U.S.C. §§ 1331-1356 (1988).

tinental Shelf. OCSLA also vests in the Secretary the sole authority and responsibility to "prescribe such rules and regulations as may be necessary to carry out such [leasing] provisions [of OCSLA]." [3] Since 1982, the Secretary has delegated the administrative responsibility for OCS leases to the MMS.[4]

OCSLA provides that the DOI obtains royalties from lessees based on the "amount or value of the production saved, removed, or sold." [5] The Secretary has promulgated several regulations relevant to a definition of this phrase. The first such provision, issued in 1954, provided that the "value of production" shall never "be less than the gross proceeds accruing to the lessee from the disposition of the produced substances." [6]

The Secretary promulgated a second regulation in 1954 which requires lessees to put extracted gas into "marketable condition" and to pay royalty on the marketable gas without first deducting for the costs of treatment.[7] The so-called "marketable condition rule" states:

> The lessee shall put into marketable condition, if commercially feasible, all products produced from the

---

[3] 43 U.S.C. § 1334(a).

[4] Secretarial Order No. 3071 (Jan. 19, 1982) [47 Fed.Reg. 4757 (Feb. 2, 1982)].

[5] 43 U.S.C. § 1337(a)(1)(A, B).

[6] 30 C.F.R. § 250.64 (1954-79) (emphasis added) [19 Fed.Reg. 2659 (May 8, 1954)], redesignated as amended at 30 C.F.R. § 206.150 (1987) [48 Fed.Reg. 35641 (Aug. 5, 1983)]. The 1983 codification was in effect during the time period relevant to this appeal. This rule has-been modified a third time but retains its essence. *See* 30 C.F.R. §§ 206.152(h) (unprocessed gas), 206.153(h) (processed gas) (1990) [53 Fed.Reg. 1272 (Jan. 15, 1988)].

[7] Treatment services performed and at issue here include measuring, gathering, compressing, sweetening, and dehydrating (desulphurization) the gas, where necessary to render it marketable.

leased land. In calculating the royalty payment, the lessee may not deduct the costs of treatment.[8]

With the NGPA,[9] Congress set price ceilings for defined categories of natural gas, representing the maximum lawful consideration due the producer-seller. Congress created the Federal Energy Regulatory Commission (FERC) to administer the new act. NGPA § 110 excepts from the ceiling price regulation certain post-production costs, allowing producers to recover these costs in addition to the unit price for delivered gas from purchasers. That section provides, in relevant part:

> . . . [A] price for the first sale of natural gas shall not be considered to exceed the maximum lawful price applicable to the first sale of such natural gas under this part if such first sale price exceeds the maximum lawful price to the extent necessary to recover—
>
> (1) State severance taxes . . .; and
>
> (2) any costs of compressing, gathering, processing, treating, liquefying, or transporting such natural gas, or other similar costs, borne by

[8] 30 C.F.R. § 250.42 (1987) [44 Fed.Reg. 61892 (Oct. 26, 1979)] *amending* 30 C.F.R. § 250.41(b) (1968) [19 Fed.Reg. 2656 (May 8, 1954)]. This provision was amended in 1988 and now provides:

> The lessee is required to place gas in marketable condition at no cost to the Federal Government or Indian lessor unless otherwise provided in the lease agreement. Where the value established pursuant to this section is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the gas in marketable condition.

30 C.F.R. § 206.152(i) (1990) [53 Fed.Reg. 1272 (Jan. 15, 1988)]; *see also* 30 C.F.R. § 206.153(i) (1990) (processed gas); *infra* note 52.

[9] 15 U.S.C. §§ 3301-3432.

the seller and allowed for, by rule or order, by the [FERC].[10]

FERC implemented § 110 through its Order No. 94 and supplemental orders [11] which provided that a first seller of natural gas may receive payment for "production-related costs" over and above the otherwise applicable ceiling price within the "first sale price." [12] "Production-related costs" is defined to include "costs, other than production costs, that are incurred: (1) To deliver, compress, treat, liquefy, or condition natural gas. . . ." [13] The amount of the reimbursements to which producer-sellers are entitled is based upon factors including the age of the pipeline gas delivery system and the difficulty of the treatment process, which often depends upon the quality of the gas.[14] The seller may also regroup other costs which the purchaser has expressly agreed to bear.[15]

Soon after they were promulgated, various natural gas pipeline purchasers and distributors challenged the reimbursement rules in several actions which reached this Court on appeal, contending that the rules were irrational and not supported by the evidence. In a consolidated decision, *Texas Eastern Transmission Corp. v. Federal Energy Regulatory Comm'n*,[16] we expressly rejected these

[10] 15 U.S.C. § 3320(a).

[11] *See* FERC Order Nos. 94, 94-A, and 94-B, codified at 18 C.F.R. §§ 271.1100-271.1106 (1990) [45 Fed.Reg. 53099 (Aug. 11, 1980); 48 Fed.Reg. 5152 (Feb. 3, 1983); 48 Fed.Reg. 5190 (Feb. 3, 1983)] [hereafter referred to as "the Order 94 regulations"]. *See also Texas Eastern Transmission Corp. v. Federal Energy Regulatory Comm'n*, 769 F.2d 1053, 1060 n. 8 (5th Cir.1985), *cert. denied*, 476 U.S. 1114, 106 S.Ct. 1967, 90 L.Ed.2d 652 (1986).

[12] 18 C.F.R. § 271.1104(a) (1990).

[13] 18 C.F.R. § 271.1104(c)(7)(i) (1990).

[14] *See* 18 C.F.R. § 271.1104(d)(1) (1990).

[15] *See* 18 C.F.R. § 271.1104(d)(2) (1990).

[16] 769 F.2d 1053.

challenges, affirming FERC's authority pursuant to NGPA § 110 to promulgate regulations which entitle natural gas producers to reimbursement for certain production-related costs.

Following this decision, the MMS reevaluated its requirement that § 110 reimbursements be included in the "gross proceeds" amount for calculating royalties due the DOI.[17] The result, a comprehensive report entitled "Policy for Production-Related Cost Payments Under Section 110 of the [NGPA] of 1978,"[18] established that the MMS considered such payments part of the value of production and the lessees' "gross proceeds" and reminded lessees that § 110 reimbursements are subject to royalty.

B. Factual and Procedural Details

Mesa owns interests in several mineral leases off the coasts of Louisiana and Texas which the DOI administers

---

[17] Both prior to and after the *Texas Eastern* decision, the MMS's policy has been to include § 110 payments in the lessees' "gross proceeds" for royalty valuation purposes. Mesa itself operated for some time under the DOI's interpretation of the royalty valuation on § 110 payments, *see infra* note 20, and stated at oral argument that the DOI Inspector-General first demanded unpaid royalties on § 110 reimbursements from Mesa in August 1983. Also, the record from the DOI hearing in this case includes documentary evidence that the MMS's policy has been consistent. *See, e.g.*, Admin. Rec. v. I.5 (July 22, 1985, Memorandum from Chief, Royalty Valuation and Standards Division to Regional Manager, Houston Office the Royalty Compliance Division of MMS, regarding royalty valuation of the El Paso Natural Gas Co., stating that "[m]onies received by the seller for production-related costs are a part of the gross proceeds accruing to the lessee and therefore are subject to royalty"). *See also* Policy Regarding Procedures for Calculating Royalty Values, Santa Fe Energy Co., enclosed with letter of May 7, 1986:

> The MMS's policy is that monies received . . . by the lessee (seller) to offset the incurrence of "production-related costs" (FERC Order 94 monies) are considered a part of the gross proceeds upon which royalties are due.

Admin. Rec. v. I.3.

[18] Admin. Rec. v. I.1.

pursuant to OCSLA. Mesa produces natural gas from various wells located on the leased lands and sells the gas to pipeline company purchasers under long-term sales contracts. Under the leases, which incorporate all applicable federal statutes and regulations, Mesa must calculate royalty payments due the DOI equal to 16⅔ percent of the value of "production saved, removed or sold" from the leased property, which it periodically pays through the MMS.[19]

After an early 1987 audit, the MMS demanded by letter dated February 27, 1987, that Mesa pay royalties on § 110 cost reimbursements Mesa had received to date. After forwarding a letter of credit to the MMS for $1,509,529.88, the amount of "disputed" unpaid royalties as of February 1987,[20] Mesa appealed the MMS's audit demand to the DOI.

On October 7, 1987, the DOI issued a final ruling affirming the MMS's position that § 110 reimbursement payments which Mesa had received were royalty-bearing

---

[19] The Mesa/DOI lease provides in part:

> *Royalty on production* [Lessee is obligated] to pay the lessor a royalty of 16⅔ percent in an amount or value of production saved, removed or sold from the leased area. Gas of all kinds (except nelium and gas used for purposes of production from and operation upon the leased area or unavoidably lost) is subject to royalty.

It is also undisputed that Mesa agreed in the lease that the Secretary of the Interior may establish minimum values for purposes of computing royalty on products obtained from the lease, "due consideration being given to the price received by the lessee," and that the terms of OCSLA and its implementing regulations are incorporated into the lease.

[20] By letter dated December 30, 1986, Mesa also sought a $954,574.12 refund of royalty on § 110 payments it claimed (under its interpretation of the regulations) it had overpaid the DOI. The February 1987 audit letter came after this refund request and began the proceedings which ultimately gave rise to this appeal. The question of the *amount* of royalty due is not before this Court, only whether the DOI may legally demand the royalty.

payments. The DOI ruling stated that the MMS policy of subjecting § 110 payments to royalty valuation was well within the "considerable discretion" accorded the Secretary "to establish for royalty purposes the value of production from Federal oil and gas leases."[21] In its opinion, the DOI based its analysis on the Marketable Condition Rule,[22] stating that the justification for treating § 110 reimbursements as royalty-bearing payments is firmly grounded in that rule's requirement that "the lessee must bear the costs of marketing the production." It declined to distinguish for royalty purposes between proceeds from the sale of produced gas and § 110 reimbursements made by pipeline company purchasers. The opinion concluded:

> The lessee has the duty to market the production from a Federal lease. Therefore, the marketing costs, like the production costs, do not qualify as a deduction from the lessee's gross proceeds received.

Mesa appealed the DOI's decision to federal district court, where Mesa and the DOI each filed cross-motions for summary judgment. The district court referred the motions to the magistrate,[23] who recommended that the DOI decision and the MMS order be upheld. Mesa argued that this Court's recent decision in *Diamond Shamrock Exploration Corp. v. Hodel*,[24] in which we defined "production" as "the actual physical severance of minerals from the formation"[25] required a holding that royalty could not be levied on § 110 reimbursements for "production-related costs" incurred well after "actual production," that is, "physical severance." In an oral

---

[21] *Id.*

[22] 30 C.F.R. § 250.42; *see supra* note 8.

[23] *See* F.R.Civ.P. 73.

[24] 853 F.2d 1159 (5th Cir.1988).

[25] *Id.* at 1167.

ruling, the district court confined the *Diamond Shamrock* definition of production to the royalty dispute over "take-or-pay" contracts at issue in that case. The court then adopted the magistrate's report and recommendation and entered judgment for the DOI. Mesa brings this appeal.

II. Standard of Review

We review the district court's grant of summary judgment *de novo*. Under the Administrative Procedure Act, however, we must not set aside the DOI's findings unless its decision was "arbitrary, capricious, or otherwise not in accordance with law." [26] In addition, because the determination at issue here involved the interpretation of a statute, the question for this Court is "whether the agency's interpretation is based on a permissible construction of the statute." [27] This standard is especially applicable where, as here, relevant statutes and regulations do not address the precise question, specifically whether § 110 payments are royalty-bearing for the benefit of the DOI-lessor.[28]

Mesa contends that the DOI's order constitutes an impermissible construction of the Gross Proceeds and Marketable Condition Rules. Section 110 payments at issue in this case should not be subject to royalty valuation under the regulations as they stood in February 1987 for three reasons: (1) the Marketable Condition Rule is irrelevant to royalty valuation of § 110 cost reimbursements; (2) the DOI's position conflicts with the policies

[26] 5 U.S.C. § 706(2)(A).

[27] *Diamond Shamrock*, 853 F.2d at 1165 (*citing Chevron, U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 843, 104 S.Ct. 2778, 2781-82, 81 L.Ed.2d 694, 703 (1984). *See also, Amoco Production Co. v. Lujan*, 877 F.2d 1243, 1248 (5th Cir.), *cert. denied*, —— U.S. ——, 110 S.Ct. 561, 107 L.Ed.2d 556 (1989) (agency's interpretation of law must be honored so long as it is a reasonable one).

[28] *See Diamond Shamrock*, 853 F.2d at 1165.

underlying the NGPA § 110, which Congress enacted in order to encourage producers to explore for new sources of lesser quality natural gas; and (3) this Court's intervening decision in *Diamond Shamrock* prohibits the DOI's broad construction of "value of production saved, removed, or sold," the benchmark for royalty assessment.

III. The Merits

A. The Marketable Condition Rule

The DOI relies heavily on the Marketable Condition Rule to reach its conclusion that § 110 payments are subject to royalty valuation. In short, the DOI interprets the regulations to provide that: royalties are due on the gross proceeds accruing to the lessee; the term "gross proceeds" includes payments for the costs of treatment including measuring, gathering, compressing, sweetening, and dehydrating "where such services are necessary to place gas in marketable condition," whether the costs are absorbed in the price the purchaser pays pursuant to the set NGPA ceiling or are ultimately borne by the purchaser under § 110; accordingly, where the purchaser reimburses the lessee for treatment costs in accordance with § 110 and the Order 94 regulations, these payments become part of the value of production (gross proceeds) subject to royalty. Mesa argues that the DOI order is unacceptable and the district court should be reversed because the regulations do not support such a construction. While Mesa's reading of the regulations may be plausible, we may reject the DOI's Order (and, consequently, the district court's judgment) only if the agency's interpretation is *impermissible* or *unreasonable*.[29] Granting this deference, we conclude that the DOI's construction certainly does not rise to this level.

[29] *See supra* notes 27-28.

Mesa does not challenge the Marketable Condition Rule itself.[30] Rather, Mesa contends that the Rule focuses on the duty to market the gas, forbidding lessees from discontinuing or interrupting the production of gas or producing and wasting gas,[31] and has no bearing on calculation of royalties on § 110 payments. Mesa acknowledges that the Marketable Condition Rule, which prohibits lessees from deducting treatment costs incurred in complying with the Rule when figuring royalty due, has some relevance to the calculation of royalties. However, Mesa contends that the Rule prohibits producers from deducting costs of treatment from the calculated royalty amount itself rather than the royalty *base* against which the royalty rate is applied (that is, the total proceeds from sale on which royalty is due).

In addition, Mesa maintains that this prohibition does not translate into an affirmative obligation to pay royalties on § 110 reimbursements for treatment costs. Such a requirement, Mesa argues, would have the anomalous result of entitling the DOI to inverse recovery of greater royalties roughly proportionate to the poor quality of the gas and the difficulty of treatment.

(i) *Consistent Application*

A review of the historical backdrop behind § 110 appears to support the DOI's attempt to attach royalties to § 110 payments.

The Natural Gas Act of 1938 (NGA)[32] introduced cost-based price ceilings for the "sale in interstate commerce

---

[30] In any event, such a challenge would be time-barred. *See* 28 U.S.C. § 2401(A); *see also Sierra Club v. Penfold,* 857 F.2d 1307, 1315 (9th Cir.1988); *Impro Products, Inc. v. Block,* 722 F.2d 845, 850 (D.C.Cir.1983), *cert. denied,* 469 U.S. 931, 105 S.Ct. 327, 83 L.Ed.2d 264 (1984).

[31] *See* E. Kuntz, *Oil and Gas* § 60.2, at 123-24 (1978).

[32] Pub.L. No. 75-688, 52 Stat. 821 (codified as amended at 15 U.S.C. §§ 717-717w (1988)).

of natural gas for resale" and entrusted the administration of this price regulation to the Federal Power Commission (FPC).[33] Originally the NGA applied only to pipelines, calculating maximum prices according to actual costs plus a reasonable rate of return and depreciation.[34] In 1954 the Supreme Court expanded the ambit of the NGA to give the FPC jurisdiction over the rates charged by producers offering natural gas for first sale.[35]

The FPC's method of regulation fluctuated over its term as administrator of producer price ceilings.[36] Following the *Phillips* mandate, the FPC set out to fix first sale prices on an individual basis, necessitating detailed studies of the rate bases and operating costs for each producer. This procedure proved to be cumbersome,[37] and in 1960 the Commission abandoned the individual assessment procedure for area rate regulation, whereby it set producer prices for an entire geographic region based on the region's average production, costs, and rates of return.[38] To induce producers to search for new supplies of natural gas, the FPC authorized producers to recoup extraordinary costs from purchasers where "special circumstances" called for such compensation.[39] The FPC con-

[33] 15 U.S.C. § 717.

[34] Pub. L. 75-688, § 4, 52 Stat. 822.

[35] *See Phillips Petroleum Co. v. Wisconsin,* 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 (1954).

[36] *See* Note, Legislative History of the Natural Gas Policy Act: Title I, 59 Tex. L. Rev. 101, 107-12 (1989) [hereafter "Legislative History of NGPA"].

[37] *See id.* at 108.

[38] Statement of General Policy No. 61-1 (Rate Standards for Independent Natural Gas Producers), 24 F.P.C. 818, 35 P.U.R.3d 195 (1960).

[39] In proceedings on the area rate regulations, the FPC stated:

> [W]e shall provide an opportunity for producers to petition for special relief from the area rate. . . . We cannot here visual-

tinued to grant such special relief even after it changed its ratemaking procedure to establish a national price for natural gas.[40] This incentive was carried over into the NGPA in sections 102,[41] 103,[42] 107,[43] 108,[44] and 110.[45]

Considering this history of ceiling price regulations, it appears that the DOI is essentially correct in its assertion that it has applied the Marketable Condition Rule consistently to all "gross proceeds," including § 110 reimbursed costs, since the Rule was promulgated in 1954. Under the NGA pricing arrangement, the FPC's area and national rate regulation programs granted producers special relief for actual costs, a scheme similar in scope and purpose to the NGPA § 110.[46] The DOI subjected the

---

> ize all of the circumstances which may serve as the basis for such relief, and will provide adequate flexibility to consider claims to such entitlement, but it is obvious that more must be shown than that the individual producer's costs exceed composite costs.

Area Rate Proceeding For Permian Basin, 34 F.P.C. 159, 180, 59 P.U.R.3d 417, 444-45 (1965) (Op. No. 468), *aff'd in part sub nom. Skelly Oil Co. v. FPC*, 375 F.2d 6 (10th Cir. 1967), *aff'd in part sub nom. Permian Basin Area Rate Cases*, 390 U.S. 747, 88 S.Ct. 1344, 20 L.Ed.2d 312 (1968) (quoted in Legislative History of NGPA, *supra* note 36, at n. 52).

[40] *See* Legislative History of NGPA, *supra* note 36, at 110-11; [1972] F.P.C. Ann. Rep. 49.

[41] 15 U.S.C. § 3312 (establishing ceiling price for "new natural gas and certain natural gas produced from the [OCS]," and granting favorable pricing treatment to gas produced as a result of new exploration).

[42] 15 U.S.C. § 3313 (giving incentives to new developmental drilling).

[43] 15 U.S.C. § 3317 (providing special pricing for "high-cost natural gas").

[44] 15 U.S.C. § 3318 (setting incentive price for "stripper wells").

[45] 15 U.S.C. § 3320; *see supra* note 10, and accompanying text.

[46] *See supra* notes 10-15, 40.

NGA special "add-on" prices to royalty assessment.[47] Mesa has been unable to convince this Court that under the NGPA the effect should not be the same.

Mesa's contention that the Marketable Condition Rule applies to the royalty amount itself rather than the royalty *base* evidences a fatal misreading of the Rule and its accepted construction, undermining much of Mesa's argument on appeal. Its reading is indeed contrary to the interpretation the DOI has given the Marketable Condition Rule for decades, that is, that marketing costs cannot be deducted from the *gross proceeds*, equal to the value of production, before royalty is calculated.[48] As the Interior Board of Land Appeals recently stated in *ARCO Oil & Gas Co.*,[49] only such marketing allowances "as have been expressly recognized may properly be deducted from

---

[47] *See e.g., The Texas Company*, 64 I.D. 76 (1957) (holding that special "handling charges" recouped from pipeline purchasers under extraordinary circumstances were royalty-bearing).

[48] *See California Co. v. Udall*, 296 F.2d 384 (D.C. Cir.1961), *aff'g* 187 F.Supp. 445 (D.D.C. 1960), *and The California Co.*, 66 I.D. 54 (1959); *Placid Oil Co.*, 70 I.D. 436 (1963).

We consider this a clear interpretation of the Marketable Condition Rule. Therefore, we decline Mesa's and amici's invitation to import commonly understood meanings of lease terms from cases decided in the state courts of this Circuit. *See* 43 U.S.C. § 1333; *Nations v. Morris*, 483 F.2d 577, 589 (5th Cir.), *cert. denied*, 414 U.S. 1071, 94 S.Ct. 584, 38 L.Ed.2d 477 (1973) (when construing OCS lease, state law only applicable when necessary to fill significant void or gap); *Continental Oil Co. v. London S.S. Owners' Mut. Insur. Ass'n*, 417 F.2d 1030, 1035-36 (5th Cir.1969), *cert. denied*, 397 U.S. 911, 90 S.Ct. 911, 25 L.Ed.2d 92 (1970) (same).

The most recent amendment to the Marketable Condition Rule expressly incorporates the DOI's interpretation that no marketing costs may be deducted from the gross proceeds on which royalty is calculated. *See* 30 C.F.R. §§ 206.152(i), 206.153(i) (1990), *supra* note 8.

[49] 115 I.B.L.A. 393 (1990).

value [of production] for royalty purposes." [50] As did the D.C. Circuit in *California Co.*, in the context of this case we define "production" in the phrase "amount or value of the production" as meaning "gas conditioned for market." [51]

Second, any anomaly which results from allowing higher royalty on lower quality gas by assessing royalty on § 110 payments is a consequence of the NGPA/FERC price regulation system and not of the scheme setting out the royalty owner's rights. Indeed, this is a uniform result. The DOI-lessor simply obtains a flat percentage of all "gross proceeds" whether they be within the ceiling price or exceed it under § 110, obtaining more royalty where the lessee obtains a greater price, including costs reimbursements, from the pipeline purchaser.[52]

---

[50] *Id.* at 396. Certain cases which Mesa and amici contend provide authority for their position instead illustrate this exception. *See e.g., Marathon Oil Co. v. United States*, 604 F.Supp. 1375 (D.Alaska 1985), *aff'd*, 807 F.2d 759 (10th Cir.1986), *cert. denied*, 480 U.S. 940, 107 S.Ct. 1593, 94 L.Ed.2d 782 (1987) (allowance for transportation to far distant market in Japan deductible).

We also point out that cases involving non-federal parties, also urged as authority by Mesa and amici, only confirm that royalty obligations are to be determined by the lease terms and incorporated statutory provisions. *See supra* note 48; *see also Bowers v. Phillips Petroleum Co.*, 692 F.2d 1015 (5th Cir.1982) (determining "market value" and royalty owing under terms of Texas lease); *Ashland Oil & Refining Co. v. Staats, Inc.*, 271 F.Supp. 571, 577 (D.Kans. 1967) (allowing deduction for post-production services under express provision in lease between non-federal parties).

[51] *See California Co.*, 296 F.2d at 388.

[52] At oral argument, counsel for Mesa for the first time suggested that the DOI's interpretation improperly results in a royalty "in value" which would be different from a royalty "in kind," in contravention of "hornbook law." This argument was neither presented to nor passed on by the district court, nor was it raised in any of the briefs to this Court. We therefore need not reach it. *See Picco v. Global Marine Drilling Co.*, 900 F.2d 846, 849 n. 4, 1990 A.M.C. 1976, 1979 n. 4 (5th Cir.1990) (argument not presented to district or circuit court before oral argument not pre-

(ii) *No Conflict With NGPA or FERC*

Moreover, because the motives behind special relief measures such as were put forth by the FPC, and by FERC pursuant to § 110, did not change, we are unconvinced that including § 110 reimbursements in the royalty-bearing "gross proceeds" from the sale of gas necessarily thwarts Congress' intention to provide incentives for exploration and production of low quality gas by allowing for producers to be reimbursed for certain actual costs. Knowing that the FPC had allowed royalties on special relief prices in the past, it was for Congress, if it had intended the incentive to be greater than under the NGA, to provide that NGPA § 110 payments not be subject to royalty.

Likewise, the DOI's royalty demand presents no conflict with FERC's Order 94 program, which this Court upheld in *Texas Eastern.*[53] Citing this Court's determination in *Diamond Shamrock* that we would not allow the DOI's royalty policy to interfere with FERC's regulation of the producer-purchaser relationship in the take-or-pay situation,[54] Mesa seizes on FERC's characterization of treatment expenses as "post-production" costs.[55] But more often FERC attaches the phrase "production-related" to

---

served for appeal); *Clark v. Aetna Cas. & Sur. Co.*, 778 F.2d 242, 249 (5th Cir.1985).

In any case, we reject Mesa's suggestion. The case which Mesa cited, *ARCO Oil Co.*, 115 I.B.L.A. 393, does not support its proposition that royalty taken in kind must always equal royalty taken in value. *See supra* note 50. Indeed, it will always be the case that royalty owners may realize some benefit from taking their royalty in kind rather than in value, or vice versa, under the proper reading of the Marketable Condition Rule, which Mesa has failed to employ. *See supra* notes 48-51, and accompanying text.

[53] 769 F.2d 1053.

[54] *See* 853 F.2d at 1167; *infra* section III.B.

[55] *See* 48 Fed.Reg. 5152, 5153 (Feb. 3, 1983).

these expenses,[56] and has nowhere indicated that this nomenclature affects or refers to royalty valuation. Absent plain meaning or contrary indications from FERC, we see no conflict.[57]

Therefore, we conclude that the DOI's construction of the impact of the Marketable Condition Rule on the royalty-bearing nature of NGPA § 110 reimbursement payments is entirely reasonable and permissible.

B. The Effect of Diamond Shamrock

Mesa relies heavily on our 1988 decision in *Diamond Shamrock*,[58] arguing that it uncategorically prohibits assessment of royalties on costs for treatment of gas after the gas is physically severed from the earth. The DOI counters, and the district court found, that *Diamond Shamrock* involved a different question than the case before us and does not provide support for Mesa's position. We agree.

In *Diamond Shamrock* we were asked to determine whether the DOI could obtain royalties on take-or-pay monies received by the producing lessee for gas not taken. We held that producers leasing offshore lands from the DOI were not required to pay royalties on monies received from pipeline purchasers as take-or-pay payments under the purchase contract.[59]

---

[56] *See* 18 C.F.R. § 271.1104(c)(7)(i) (1990) [48 Fed.Reg. at 5153], *supra* note 13.

[57] This is unlike *Diamond Shamrock*, 853 F.2d at 1167-68, discussed *infra* Section III.B, where the conflict was clear. Generally speaking, as with the NGPA, Order 94 is directed to the producer-purchaser relationship and does not address allocation of payments under the lease between the DOI-lessor and the producer-lessee, which is governed by regulations originally enacted some 27 years earlier. *See supra* notes 6-8.

[58] 853 F.2d 1159.

[59] *Id.* at 1168.

Our discussion focused on the meaning of "production" in the context of OCSLA § 8, which requires that royalty be based on the "amount or value of the production saved, removed, or sold." [60] We concluded that take-or-pay provisions provide payment for the pipeline-purchaser's *failure* to purchase gas, and therefore could not be royalty-bearing as a sale of "production" under OCSLA.[61] *Diamond Shamrock* had nothing whatsoever to do with treatment costs, the Marketable Condition Rule, or § 110 reimbursement payments. We did not interpret these concepts, nor was there any reason that we should have. Nor did we resolve or address the question of how to assess the "fair market value" of gas produced. In essence, we held that royalty valuation could not *begin* until gas constitutes "production saved, removed or sold" —physically severed "from the formation" and "delivered to the pipeline."[62]

But we know that this does not end the inquiry. Where the producer treats the gas, as is required under the Marketable Condition Rule, royalties are not assessed on the value of the gas in raw form, or exclusive of costs, but on the "gross proceeds" received from the purchaser, often the ceiling price mandated under the NGPA, *without deduction for the costs of marketing.*[63] To contend, as Mesa does, that our definition of "production" in *Diamond Shamrock* mandates a distinction between proceeds accruing from sale of the gas itself and reimbursement receipts for the producer's treatment of the gas would lead to absurd results in contravention of the Marketable Condition Rule and the plain meaning of the standard phrase "*gross proceeds.*" [64] *Diamond Shamrock* does not allow this quantum leap.

---

[60] *Id.* at 1165-67. *See* 43 U.S.C. § 1337(a)(1)(A, B), *supra* note 5.

[61] *See id.* at 1167.

[62] *Id.* at 1168, 1165

[63] 30 C.F.R. § 250.42 (1987), *supra* note 8.

[64] 30 C.F.R. § 206.150 (1987), *supra* note 6.

Conclusion

For the foregoing reasons, we conclude that the district court properly determined that the DOI correctly interpreted the regulations as they apply to royalty owing on § 110 reimbursements.

AFFIRMED.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 89-4775

MESA OPERATING LIMITED PARTNERSHIP,
Plaintiff-Appellant,

versus

U.S. DEPARTMENT OF THE INTERIOR,
Defendant-Appellee.

Appeal from the United States District Court for the Western District of Louisiana

ON PETITION FOR REHEARING

(June 27, 1991)

Before BROWN, POLITZ and JOHNSON, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby DENIED.

ENTERED FOR THE COURT:

/s/ [Illegible]
United States Circuit Judge

APPENDIX B

IN THE UNITED STATES DISTRICT COURT FOR
THE WESTERN DISTRICT OF LOUISIANA
LAKE CHARLES DIVISION

Civil Action No. 88-0414-LC

(Judge Veron)

MESA OPERATING LIMITED PARTNERSHIP

vs.

UNITED STATES DEPARTMENT OF INTERIOR

JUDGMENT

[Filed Aug. 23, 1989]

For the reasons dictated into the record on August 22, 1989;

It is hereby ORDERED, ADJUDGED AND DECREED that there be judgment herein in favor of the United States Department of the Interior and against Mesa Operating Limited Partnership, dismissing Mesa Operating Limited Partnership's suit with prejudice and at its costs.

JUDGMENT SIGNED in Chambers at Lake Charles, Louisiana, this 23rd day of August 1989.

/s/ Earl E. Veron
EARL E. VERON
United States District Judge

Judgment Entered 8-24-89

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF LOUISIANA
LAKE CHARLES DIVISION

Cv. No. 88-0414

MESA OPERATING LIMITED PARTNERSHIP, *et al.*

versus

UNITED STATES DEPARTMENT OF INTERIOR

Proceedings Had Before THE HONORABLE EARL E. VERON, United States District Judge, At Lake Charles, Louisiana, Beginning on the 22nd Day of August, 1989

* * * *

[141] THE COURT: All right. The court is called upon to determine whether the Report and Recommendation of the Magistrate in this case should be adopted or accepted as the law in this case, or whether the Report and Recommendation should be changed in accordance with plaintiff's arguments. It goes without saying that not only have the parties been given a hearing before the magistrate, and full opportunity to brief the matter with the magistrate, [142] but then subsequent to the magistrate's ruling or recommendation, this court has received a number of briefs, and reply briefs, and surreply briefs, up until just about this hearing. This court has taken the entire record and reviewed it from the beginning to the end. And the question before the court is should the report and recommendation of the magistrate

be adopted by this court, or should they be amended or changed. The issue, as I understand it, in this case, is how are royalties to be calculated, paying to the government for offshore leases it has entered into with private concerns. I have listened attentively to the arguments. And the arguments are, for one thing, that the price of gas is at the wellhead. I am cited the case of Diamond Shamrock Exploration Corporation versus Hodel, which is a Fifth Circuit opinion by Judge Brown, at 853 F. 2d. 1159, and which opinion also covers a case that was decided by this court in the case of Mesa Petroleum Company versus the U.S. Department of Interior, at 647 F. Supp. 1350. In these two cases, the question before this court, and also before the Fifth Circuit, was a question of when is the government entitled to royalty on a take-or-pay situation. This court so ruled, and the Fifth Circuit affirmed this court in the Diamond Shamrock case in holding that the minerals must be severed from the soil in order for there to be royalties, for the government to be entitled to royalties. [143] And in particular, we got into the subject of what is production. Now, the case before this court today is the question of not whether there has been production, but how do you value the production in order for the government to receive its royalty of sixteen and two-thirds percent as lessor. It is argued by the plaintiffs that the price should be the value at the wellhead. That simply means once you bring it to the surface that is the value the royalty owner is entitled to, not anything as to the price that you receive from the first sale. The government regulations talk about what is to be deducted, and how do you arrive at what is the value of production. And the secretary and the regulations, the Department of Energy regulations state at 30 CFR 206.150, and we are talking about what is the value of production, the value of production shall never be less than the fair market value. And then leaving out some words, under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee.

Now, of course, this is a 1986 regulation, but it is applicable prior to 1986, because it just makes sense to this Court that in determining what is the market value to determine royalty that the market value has to be on some value. Now, what is the value? Judge Brown, in the Diamond Shamrock case, at page 1165, said this, quote, the secretary's interpretation of value does not comport with the plain meaning of the words in the lease, and [144] in the relevant statutes and regulations. It is obvious from a complete reading of all the relevant statutes, regulations and lease provisions that royalties are not due on value, or even market value in the abstract, and the words value and market value are in quotes, but only on the value of, and emphasis by the court, production saved, removed and sold, emphasis ended, from the lease property. Likewise, the agency's regulations do not refer to gross proceeds in the abstract, but to only the gross proceeds that accrue to the lessee from the disposition or sale of, and emphasis added by the court, produced substances, emphasis ended, that is gas actually removed and delivered to the pipeline. Consequently, royalties are not owed unless until actual production and the severance of the minerals from the formations occur, close quotes. I interpret this to mean exactly what Judge Brown said. He talks about gas actually removed and delivered to the pipeline when you are talking about production. Now, in this case, what is the government entitled to the royalties on? It is entitled to the gross proceeds that the seller gets at the first sale. And the gross proceeds mean to me exactly what Judge Brown said. And that the lessee may not deduct the cost of sweetening, treating and so forth in determining what the royalties are. I have thought long and hard about this case, and I have kicked it around in my mind. And it has been on my mind for [145] over a week trying to figure out how this case is to come out. I cannot find any reason to disagree, in anyway, with

the magistrate's report and recommendation. I find that his findings of fact are correct, and his conclusions of law are correct. And for these reasons, I will adopt and order and render judgment in favor of the defendant granting motion for summary judgment, denying the plaintiffs' motion in this case. And, ladies and gentlemen, I want to thank you. And, of course, I know the case will be appealed, and it should be appealed because it is the type that should be appealed. But I don't think you all will have to do much more work in it because you just use your briefs and submit them to the Fifth Circuit. And I can tell you now, that certainly the Court of Appeals could disagree with my interpretation. But that is mine. And I have to live with it. And if they say I am wrong, and then they send it back to me for further action, I will take it. But again, I want to thank all of you, and say that it has certainly been interesting. You had knowledgeable attorneys on all sides concerning what we are talking about today. I am not quite sure that I understood everything, but I think I did. And so with that then, I will sign a judgment within the next day or two, and you will be receiving copies of it. Thank you very much. This Court stands in adjournment.

(Proceedings closed. Court adjourned.)

CERTIFICATE

I, Joe D. Williams, Official Reporter, United States District Court, Western District of Louisiana, do hereby certify the above and foregoing 145 pages of typewritten matter constitute a true and correct copy of proceedings had at the time and place as hereinbefore set forth on page one hereof.

In witness whereof, I have hereunto affixed my signature at Lake Charles, Louisiana, this the 7th day of September, 1989.

I further certify that the transcript fees and format comply with those prescribed by the Court and Judicial Conference of the United States.

/s/ Joe D. Williams
JOE D. WILLIAMS

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF LOUISIANA
LAKE CHARLES DIVISION

Civil Action No: 88-0414 LC

Judge Earl E. Veron

MESA OPERATING LIMITED PARTNERSHIP,
Plaintiff

versus

UNITED STATES DEPARTMENT OF THE INTERIOR,
Defendant

REPORT AND RECOMMENDATION OF MAGISTRATE

[Filed Apr. 14, 1989]

This is a suit for injunctive relief and declaratory judgment arising from the demands of the Mineral Management Service of the Department of the Interior (referred to herein as "MMS" and "DOI") for royalties and late payment charges on cost reimbursements that Mesa Operating Limited Partnership was authorized to receive in accordance with Section 110 of the Natural Gas Policy Act ("NGPA") for performing certain closed production services with respect to natural gas produced from various federal leases issued under the provisions of the Outer Continental Shelf Lands Act ("OCSLA"). Plaintiff, Mesa Operating Limited Partnership ("Mesa") alleges that MMS's demand for royalties and late payment charges on these costs reimbursements contravenes the provision of OCSLA, the provisions of the NGPA, DOI's

own regulations, and the provisions of the applicable leases.

This court has jurisdiction of this action pursuant to 5 U.S.C. §§ 701-706 and 28 U.S.C. §§ 1331 and 1346. Both parties filed for summary judgments. Since no genuine issues of material fact exist in the present case, the legal issues will be decided on cross motions for summary judgment.

BACKGROUND

Mesa owns an interest in several mineral leases covering submerged lands located on the Outer Continental Shelf off the coast of Louisiana and Texas. Each of the leases was issued by the Department of Interior pursuant to the Outer Continental Shelf Lands Act of 1953, 43 U.S.C. § 1331, *et seq.*, and the regulations contained in 30 C.F.R. § 200, *et seq.*. Mesa produces natural gas from various wells located on its offshore federal leases. This natural gas is generally sold to pipeline purchasers under long term natural gas sales contracts. In general, Mesa's sales contracts require the purchaser to pay for natural gas at the maximum selling price permitted by federal law. In most cases, the price which Mesa can charge for natural gas is limited by rules issued pursuant to the provisions of the Natural Gas Act ("NGA"), 15 U.S.C. § 717 *et seq.*, or the Natural Gas Policy Act of 1978, 15 U.S.C. § 3301 *et seq.*, which are administered and enforced by the Federal Energy Regulatory Commission ("FERC"). Price ceilings established under those statutes apply to gas at the wellhead. Those ceiling prices represent the maximum lawful consideration which Mesa can receive for the natural gas itself.

Under the leases, Mesa is obligated to pay royalties to the United States for natural gas produced from the leased premises. Specifically, the leases provide as follows:

> *Royalty on production* [Lessee is obligated] to pay the lessor a royalty of 16 2/3 percent in an amount

> or value of production saved, removed or sold from the leased area. Gas of all kinds (except helium and gas used for purposes of production from and operation upon the leased area or unavoidably lost) is subject to royalty.

The authority to enter such leases is granted to the Secretary by the OCSLA, which was enacted in 1953 to give the Secretary of the Interior authority to issue oil and gas leases for tracts on the Federal Outer-Continental Shelf. The purpose of the Act, then and as amended, is to "establish policies and procedures for managing the oil and natural gas resources of the [OCS]". 43 U.S.C. § 1802(1) (1978). Section 5(a) of the OCSLA gives the Secretary of Interior the authority and responsibility "to prescribe such rules and regulations as may be necessary to carry out such provisions [of the Act]" 43 U.S.C. § 1334(a). The OCSLA does not define the phrase "value of the production saved, removed or sold" but leaves that determination to the Secretary in the exercise of his ruling and authority.

DOI's regulations have consistently required lessees to treat gas to put it into marketable condition, and to pay royalty on the value of gas in marketable condition without deduction for costs of treatment. This rule dates from 1954:

> The lessee shall put into marketable condition, if commercially feasible, all products produced from the leased land *and pay royalty thereon without recourse to the lessor for deductions on account, costs and treatment.*

30 C.F.R. 250.41(b) (1969) (emphasis added), promulgated at 19 Fed.Reg. 2656 (May 8, 1954). The "marketable condition" requirement was amended but reaffirmed in 1979.

> Lessee shall put into marketable condition, if commercially feasable, all products produced from the

leased land. *In calculating royalty payment, the lessee may not deduct the costs of treatment.* 30 C.F.R. 250.42 (1986) (emphasis added).

CASE HISTORY

On February 27, 1987, Mesa received an audit letter from MMS demanding that Mesa pay royalty on all cost reimbursements the company had received after July 25, 1980 for post-production services performed pursuant to Section 110 of the NGPA. MMS's audit letter also stated that failure by Mesa to comply with the letter would be considered a violation of 30 C.F.R. § 3241.51(a)(3) and could subject Mesa to penalties of $5,000.00 per violation per day.

On April 9, 1987, Mesa filed a notice of appeal with the MMS with respect to the orders and directives set forth in the February 27, 1987 audit letter. In that notice, Mesa asserted that MMS's orders should be rescinded because MMS lacked statutory, regulatory, and contractual authority to collect royalties or reimbursements for post-production costs. On April 13, 1981, MMS sent a letter notifying Mesa that Mesa had until May 19, 1982 to comply with the February 21, 1982 order. On April 30, 1987, Mesa requested a stay pending appeal of that portion of the February 27, 1987 audit letter requiring payment of royalties allegedly owed on post-production reimbursements.

On July 17, 1987, MMS agreed to stay the requirement to pay the disputed royalty, which was calculated to be $1,179,631.30, provided Mesa post a letter of credit in the amount of $1,509,529.88, which amount included principal and interest through July 31, 1987. On August 1, 1987, Mesa provided MMS with such a letter of credit, which was subsequently increased to reflect interest accruing after January 1, 1988.

Subsequently, the Assistant Secretaries for Land and Minerals Management and Indian Affairs and the Di-

rector of the Minerals Management Service issued a decision denying Mesa's appeal. They explained:

> It has been the consistent policy of MMS to include in gross proceeds reimbursements received by the lessee for the performance of services such as measuring, gathering, compressing, sweetening, and dehydrating where such services are necessary to place gas in marketable condition. The conclusion that royalty is payable when the lessee is contractually entitled to reimbursement follows from the requirement that the lessee market production and act for the mutual benefit of both itself and the lessor. *Nola Grace Ptasynski*, 89 I.D. 208, 63 IBLA 240 (1982).
>
> That the lessee must bear the costs of marketing the production is well settled. The regulations issued by the Secretary include the [marketable condition] requirement in 30 CFR 250.42 (1986) . . .

A.R. II.1, Decision, *Mesa Operating Limited Partnership*, Appeal of Order Assessing Additional Royalties, September 29, 1987 at 2-3.

On October 7, 1987, the Director of the MMS issued a final decision in response to Mesa's appeal. In that decision, the Director first claimed that the Secretary of Interior has "considerable discretion" in establishing the value of production for royalty purposes and that the Secretary has exercised that discretion with respect to OCSLA royalties by the regulation set forth in 30 C.F.R. § 206.150.

DOI then proceeded to uphold MMS's demand for royalties, stating that "[t]he conclusion that royalty is payable when the lessee is contractually entitled to reimbursement follows from the requirement that the lessee market production for the mutual benefit of both itself and the lessor." Decision at 2.

Mesa then filed the complaint in this action seeking to have the Department of Interior's demand for royalty

and costs reimbursement for post-production services declared to be in violation of applicable laws and regulations in the leases, and enjoining enforcement of MMS's and DOI's orders requiring payment of such royalties.

ANALYSIS OF LAW

Mesa's case depends on their interpretation of *Diamond Shamrock Exploration Co., et al v. Hodel*, 853 F.2d 1159 (5th Cir. 1988). In *Diamond Shamrock*, the Fifth Circuit held that under OCSLA, MMS could not collect royalties on take-or-pay payment received by the lessee.[1]

Part of the court's reasoning for striking that interpretation was:

> [t]he position taken by the Secretary also runs into conflict with certain regulations promulgated by the Federal Power Commission and its successor, the (FERC). The FERC regulation and decisions attribute take-or-pay payments to make-up gas only

[1] Take-or-pay payment provisions require the purchaser to take a specified minimum quantity of gas during a particular period or to pay for that quantity even if not taken in full. They also provide a "make-up" period in which purchaser may take gas in excess of required minimum quantities and credit previous take-or-pay payment against the amount which otherwise would be due for such takes. (so called "make-up gas"). However, the producer keeps the entire take-or-pay payment even if the purchaser does not take the make-up gas to which it is entitled.

In effect, then, the take-or-pay obligation operates much like a quantity discount. If the purchaser takes the required minimum under the contract, it pays an agreed price; if it takes less than the required minimum, it pays more for what it does take.

The take-or-pay requirement assures the lessee-producer the minimum return revenue flow under the gas sales contract, thereby insuring that it will be able to meet the on going operations, investment, and maintenance costs of its production facilities. The purchaser obtains an exclusive, steady, and adequately long-term gas supply. *See e.g., Universal Resources Corp. v. Panhandle Eastern Pipeline Co.*, 813 F.2d 77, Ed. (5th Cir. 1987), and *Diamond Shamrock, supra*, 853 F.2d at 1167.

when the gas is actually taken. For rate-making purposes, FERC treats take-or-pay payments as prepayments for the gas not taken. 853 F.2d at 1167.

The court was struck by the fact that DOI's position was the opposite of FERC's; DOI counted the take-or-pay payments as part of the consideration of all of the gas taken under the contract (including gas previously delivered), whereas FERC reported take-or-pay payments as consideration for "make-up" gas only. In that case, Mesa argues, the court defined production as "the actual physical severance of materials from the formation." *Diamond Shamrock* at 1168. Thus Mesa contends, the value of production for royalty purposes is *limited* to the value of the severed mineral at the wellhead. To Mesa, contrary to DOI's position, the value of production cannot be expanded to include the value of services that are voluntarily performed by the lessee after the natural gas is produced at the wellhead anymore that it can be expanded to include take-or-pay payments.

Such a position is not acceptable. First, there has been a clear directive in place in DOI's regulations for decades to lessees that they will operate their leases in the following manner:

> The value of production should never be less than the fair market value. . . . *under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee. . . .*

30 C.F.R. 206.150 (186)

> The lessee shall put into marketable condition, if commercially feasible, all products used from the leased land. *In calculating the royalty payment, the lessee may not deduct the costs of treatment.* 30 C.F.R. 250.42 (1986) (emphasis added).

The agency's decision challenged before this court relies unambiguously on the "marketable condition" regulation in reaching its conclusion:

That the lessee must bear the costs of marketing the production is well settled. The regulations issued by the Secretary include the requirement in 30 C.F.R. 250.42 (1986) that:

> The lessee shall put into marketable condition if commercially feasible, all products produced on the leased land. In calculating the royalty payment, the lessee may not deduct the costs of treatment.

> This concept in the OCS regulation was carried over from the predecessor onshore regulations that have contained this [marketable condition] provision for over four decades. 40 C.F.R. 316.7-A(a) (1986).

> The issue has been appealed numerous times, and the Department of Interior has consistently held that the costs of gathering, dehydration, and compression of gas produced on a Federal lease may not be deducted when computing the royalty value against which the royalty rate is applied . . . To ignore the reimbursement received under FERC Order No. 94 would invalidate the rule that has been in place for over four decades which prohibits reduction in the royalty value that results from allowing a deduction for marketing costs. Decisions on appeal, against Mesa Operating Limited Partnership, No. MMS-87-0229-IND, at 2-3 (citations omitted).[2]

Unlike the take-or-pay issue, which was being litigated for the first time in *Diamond Shamrock*, the rules at issue in this proceeding have been in force and upheld in the administrative and judicial proceedings for dec-

---

[2] It should be noted that Mesa quietly abided by these regulations for some time in paying royalties on reimbursements for costs of treatment under other federal leases. Nothing in Diamond Shamrock or in the OCSLA's provision for royalty on "the value of the production saved, removed or sold" from a lease, 43 U.S.C. 1337, suggest that royalty is limited to the value of gas in its raw condition as severed from the reservoir.

ades. In *California Co. v. Udall*, 296 F.2d 384 (D.C. Cir. 1961), the Court of Appeals for the District of Columbia Circuit held that DOI's interpretation of the "value of production moved or sold" within the meaning of the Mineral Leasing Act means the value of gas conditioned for market. 296 F.2d at 388. As far back as 1956, DOI included reimbursements for the costs of treatment in the royalty basis.

The *Diamond Shamrock* decision turned on the Fifth Circuit's conclusion that the particular proceeds at issue (take-or-pay payments) were not attributable to gas which had been produced. Instead, the Fifth Circuit held that the proceeds were attributable only to gas which may be produced and taken in the future, against the price of which the earlier take-or-pay payments could be credited (i.e., so-called "make up" gas). Consequently, the Fifth Circuit held that no royalty was due until "make-up" production occurred.

Here, by contrast, the gross proceeds upon which DOI assessed royalties were paid on gas produced and delivered to Mesa's gas purchasers. Thus, the issue here is not whether "production" has occurred or whether certain proceeds correspond to past production as opposed to production which may only occur in the future. Rather, it is whether proceeds paid to Mesa by its purchasers for delivered gas are part of the value of that production. The *Diamond Shamrock* decision therefore has no bearing on the particular issue before this court.

Moreover, Mesa's assertion that *Diamond Shamrock* stands for the conclusion that royalties may be assessed only on natural gas "at the wellhead" necessarily implies that the Fifth Circuit meant by its decision to repudiate the Department's regulations and all of the precedent including reimbursements for costs of treatment within the federal lessees' royalty basis. However, nothing in the Fifth Circuit's reasoning suggests any intention to discredit, reject or overrule the terms of those regulations

or the administrative decisions. Likewise, nothing in *Diamond Shamrock* or in the OCSLA's provision for royalty on "the value of the production saved, removed or sold" from a lease, 43 U.S.C. 1337, suggests that royalty is limited to the value of gas in its raw condition as severed from the reservoir. *Diamond Shamrock* simply does not address the issues now before the court.

In addition, Mesa cites cases interpreting state and private lease terms to conclude that DOI's regulations could not survive legal challenge. However, federal law and leases control here, not state or private lease provisions. *See e.g.* Kuntz, *Law of Oil and Gas*, § 40.4-5; Williams and Myers, *Oil and Gas Law*, § 645.1. No case cited by Mesa construed or struck down requirements such as those set forth in DOI's regulations here. In its federal lease, Mesa clearly agreed to abide by DOI's regulations applicable to lessees. Mesa cannot avoid those regulations by citing state law construing state leases.

Local laws are incorporated into the OCSLA only to fill substantial gaps in the coverage of federal law and regulations. *State of Louisiana v. United States*, 656 F.Supp. 1310, 1320 (W.D. LA. 1986), *aff'd.* 832 F.2d 935 (5th Cir. 1987), *cert. denied*, 56 U.S.L.W. 3753 (May 2, 1988) (No. 87-1317). Federal regulations applicable to federal oil and gas lessees for decades reveal no gap or void in federal coverage of the royalty valuation issues presented here justifying resort to state or industry practice. The federal government has expressly addressed the issue of royalties on reimbursements for the costs of placing production in marketable condition through the federal lease terms and the regulations expressly incorporated therein. We find no "substantial gap in the coverage in the federal law. . ." The principal is clear that royalty obligations are to be determined by the lease terms, and any incorporated terms or regulatory conditions.[3]

---

[3] *See Davis v. CIG Exploration, Inc.*, 789 F.2d 328, (5th Cir. 1986) (interpreting the term "market price" under Texas law);

We also reject Mesa's argument that DOI's assessment of royalties on treatment costs reimbursed to the lessee violates the Natural Gas Policy Act, 15 U.S.C. 3301 *et seq.* Mesa fails to demonstrate any indication in either the NGPA or the FERC orders that Congress or FERC meant to amend DOI's long-standing royalty program. DOI royalty evaluation regulations in effect under the OCSLA since 1954 and under the MLA since 1942 have required payment of royalties on the gross proceeds accruing to federal lessees, which include payments to the lessees for costs of placing the production in marketable condition. Nothing in the NGPA or the FERC orders purported to change those DOI regulations, or in any way to denounce them. The significance of the 1978 amendments to Section 110 of the NGPA and its implementing orders and regulations is that FERC confirmed by the regulation what DOI already knew and implemented in its own program—that gas producers/lessees often incur production-related costs which they pass on to gas purchasers in sales contracts. Nothing from this scheme indicates the inconsistency between DOI regulations and FERC regulations. *Flowers v. Diamond Shamrock Corp.*, 693 F.2d 1146 (5th Cir. 1983).[4]

Pine Woods Country Life School v. Sheltwell Co., 726 F.2d 225 (5th Cir. 1984), *cert. denied,* 471 U.S. 1005 (1985); *Phillips Petroleum Co. v. Johnson,* 155 F.2d 185 (5th Cir. 1946) (royalty depends on terms of contract).

[4] FERC's discussion of costs is explained in FERC order 94-A:

> [U]nder the NGPA, the maximum lawful prices are to apply to any first sale. While this may be a sale at a wellhead, it can also be a sale from a gathering system or the tailgate of a conditional plant. The NGPA, through the definition of "first sale", leaves to contracting parties the determination of what services the producer must provide to receive any price up to a maximum lawful price. In short, the fact that producers may have to incur production-related costs under the terms of their gas sales contract in return for a maximum lawful price is not inconsistent with the congressional intent in setting maximum lawful prices for first sales. FERC no. 94-A, 48 Fed.Reg. 158 (February 3, 1983).

CONCLUSION

The Fifth Circuit's opinion in Diamond Shamrock's did *not* resolve or address the question of how to determine "fair market value" of gas undisputably produced. No reason exists before this court why lease terms requiring Mesa to pay royalties on the costs of treatment should not be upheld. Therefore it is recommended that defendant's motion for summary judgment be granted and the plaintiff's motion for summary judgment be denied, dismissing the plaintiff's case with prejudice, costs to be paid by plaintiff.

Under the provisions of 28 U.S.C. § 636(b)(1)(C), failure to file written objections to the proposed findings and recommendations contained in this report within ten (10) days from the date of service can result in the waiver of a de novo district court review.

THUS DONE AND SIGNED this 14th day of April in Lake Charles, Louisiana.

/s/ James T. Trimble, Jr.
JAMES T. TRIMBLE, JR.
United States Magistrate

APPENDIX C

UNITED STATES DEPARTMENT OF THE INTERIOR
OFFICE OF THE SECRETARY
Washington, D.C. 20240

Sep. 29, 1987

[SEAL]

MMS-87-0229-IND

MESA OPERATING LIMITED PARTNERSHIP,
Appellant

Federal Offshore Oil and Gas Leases

Appeal of Order Assessing Additional Royalties

Appeal Denied

Statement of Facts

This appeal involves a February 27, 1987, order issued by the Regional Manager, Tulsa Regional Compliance Office, Minerals Management Service (MMS), directing Mesa Operating Limited Partnership (Mesa) to compute and pay royalties on payments received by Mesa pursuant to Federal Energy Regulatory Commission (FERC) Order Nos. 94 and 94-A in connection with Mesa's Federal and Indian leases.

The FERC Order Nos. 94 and 94-A allow producers to collect from their customers an amount in excess of the FERC ceiling price as compensation for compression, gathering, processing, treatment, liquefication, and transportation of natural gas.

The question posed by this appeal is whether the reimbursements paid to the Appellant pursuant to FERC Order Nos. 94 and 94-A are royalty bearing with respect to Federal and Indian leases.

Analysis

It is well established that the Secretary of the Interior (Secretary) has the authority and considerable discretion to establish for royalty purposes the value of production from Federal oil and gas leases. *United States v. Ohio Oil Co.*, 163 F.2d 633 (10th Cir. 1947); *Continental Oil Co. v. United States*, 184 F.2d 802 (9th Cir. 1950); *Marathon Oil Co. v. United States*, 604 F. Supp. 1375 (D. Alaska 1985); *Amoco Production Co.*, 29 IBLA 234 (1977).

The Secretary's exercise of that discretion with respect to Outer Continental Shelf (OCS) leases may be found in 30 CFR 206.150 (1986) and in 30 CFR 206.103 (1986) with respect to Federal onshore and Indian leases. These regulations expressly provide that royalty value shall never be less than the fair market value and that royalties shall be paid on no less than the gross proceedings accruing to the lessee.

It has been the consistent policy of MMS to include in gross proceeds reimbursements received by the lessee for the performance of services such as measuring, gathering, compressing, sweetening, and dehydrating where such services are necessary to place gas in marketable condition. The conclusion that royalty is payable when the lessee is contractually entitled to reimbursement follows from the requirement that the lessee market production and act for the mutal benefit of both itself and the lessor. *Nola Grace Ptasynski*, 89 I.D. 208, 63 IBLA 240 (1982).

That the lessee must bear the costs of marketing the production is well settled. The regulations issued by the Secretary include the requirement in 30 CFR 250.42 (1986) that:

> The lessee shall put into marketable condition if commercially feasible, all products produced from the leased land. In calculating the royalty payment, the lessee may not deduct the costs of treatment.

This concept in the OCS regulations was carried over from the predecessor onshore regulations that have contained this provision for over four decades. 43 CFR 3162.7-1(a) (1986).

This issue has been appealed numerous times, and the Department of the Interior has consistently held that the costs of gathering, dehydration, and compression of gas produced on a Federal lease may not be deducted when computing the royalty value against which the royalty rate is applied. *The Texas Company*, 64 I.D. 76 (1957); *The California Company*, 66 I.D. 54 (1954), *aff'd*, 296 F.2d 384 (D.C. Cir. 1961); *Placid Oil Company*, 70 I.D. 438 (1963). To ignore the reimbursement received under FERC Order No. 94 would invalidate the rule that has been in place for over four decades which prohibits reduction in the royalty value that results from allowing a deduction for marketing costs.

The Appellant seeks to draw a distinction between proceeds from the sale of production and the reimbursement of various costs paid to the producers by the pipeline company purchaser. If the Appellant's logic were accepted, the producer could structure its contract with the buyer so that the producer would merely be reimbursed for the drilling of a well or the construction of an offshore platform.

The lessee's royalty obligation is not a function of net profits or net costs. The royalty is a function of the value of the production, which, at a minimum, is the lessee's gross proceeds from the disposition of production. Gross proceeds include FERC Order No. 94 reimbursements.

The primary factor to be analyzed in determining the value of the production is the amount paid by the pur-

chaser to the producer. The total proceeds paid are significant. The fact that part of the proceeds are labeled as a reimbursement for costs may be meaningful to the producer and purchaser but is not controlling in the determination of the royalty value of the production.

Conclusions and Order

The lessee has the duty to market the production from a Federal lease. Therefore, the marketing costs, like the productions costs, do not qualify as a deduction from the lessee's gross proceeds received. The total payments received by the lessee, including reimbursements for marketing the product, are properly recognized when computing the royalty value of the gas production.

Therefore, for the reasons stated herein, the subject appeal is denied.

Because this decision is issued by an Assistant Secretary of the Department of the Interior, it is not subject to appeal to the Interior Board of Land Appeals and is the final action of the Department. *Blue Star, Inc.*, 41 IBLA 333 (1979).

/s/ Wm. D. Bettenberg
Director
Minerals Management Service

/s/ James E. Cason
Acting Assistant Secretary—
Land and Mineral Management

/s/ [Illegible]
Assistant Secretary—
Indian Affairs